January 1961

THE CANADIAN CHARTERED ACCOUNTANT

THE CANADIAN INSTITUTE OF CHARTERED ACCOUNTANTS

Doing Business Abroad

The Lawyer in Estate Planning

Tax Treatment of Patents in Canada

Introduction to Punched Card Accounting

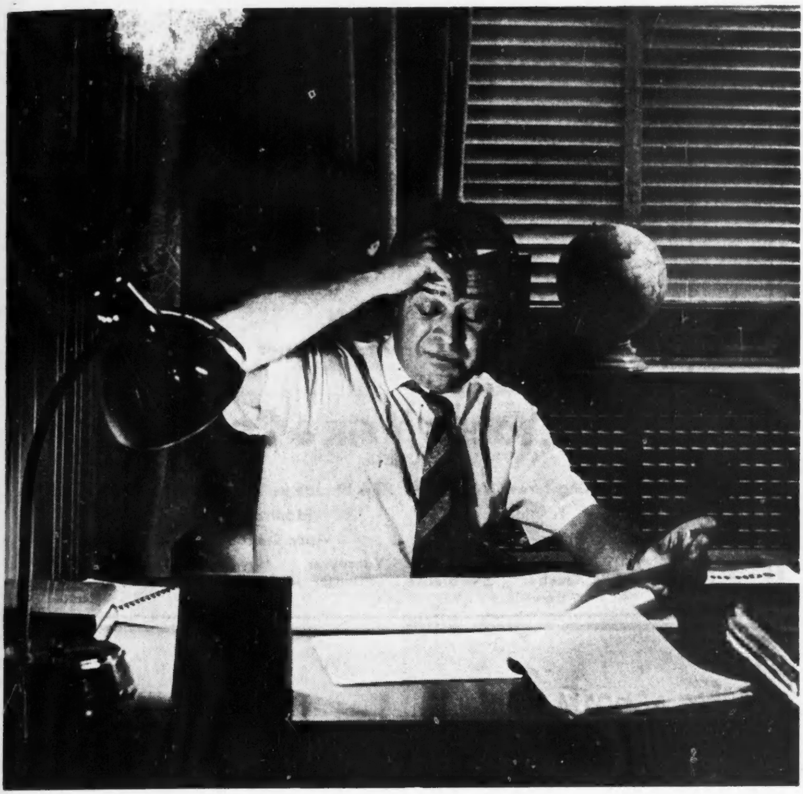
New Developments in Industrial Pension Planning

Accounting for Price Level Changes

PRACTITIONERS FORUM: Auditing Small Business II

ACCOUNTING RESEARCH: Disclosure in Financial Statements

TAX REVIEW: Canadian Tax Foundation Conference



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THE CANADIAN CHARTERED ACCOUNTANT

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IN THIS ISSUE

H. E. CRATE, F.C.A. (page 21)

An increasing number of Canadian companies are seeking ways of carrying out operations abroad to the best advantage and one method of doing this is to set up an organization in a country which (1) does not levy any income tax at all, (2) does not levy tax on holding companies and (3) exempts the foreign income of domestic corporations from tax. In "Doing Business in Foreign Countries", Harold E. Crate shows how Canadian companies can benefit by operating in so called tax-haven countries and explains the various ways of organizing a business in order to take full advantage of such tax relief.

The author is a partner in the Toronto office of Thorne, Mulholland, Howson & McPherson. He is a past president of the Institute of Chartered Accountants of Ontario and of the Public Accountants Council of Ontario. He is also a past governor of the Canadian Tax Foundation. He was elected a Fellow of the Institute in 1947.

R. deWOLFE MacKAY, Q.C. (page 28)

In "The Lawyer in Estate Planning" Robert deWolfe MacKay emphasizes what has been stressed in numerous estate planning articles published from time to time in this journal: that no one profession can assume the exclusive right to plan estates and that the interests of the person concerned can best be served by an estate planning team, working together and sharing their knowledge and experience in this type of work. Drafting legal documents, a comprehensive knowledge of statutory enactments and the interpretation of common and civil law make the lawyer's function of key importance and are vital factors in the planning of an estate.

Mr. deWolfe MacKay is a partner in the Montreal law firm of Duquet, MacKay and Weldon. After graduating from McGill University he became a lecturer there and was called to the Bar of Quebec in 1932. He is a former chairman of the Canadian Tax Foundation and has written numerous articles on tax matters including "Tax Avoidance versus Evasion" (*CCA*, February 1960).

J. F. COATE (page 35)

Business managements are facing a relatively new and rapidly growing problem: how to set up pension plans which will provide *adequate* retirement incomes for their employees. Despite the fact that considerable thought is being given to improving pension plans and to the principles in pension fund investment, many firms are finding that current pensions for their employees on retirement simply are not adequate. Such a situation, if allowed to continue, writes J. Fraser Coate, in "New Developments in Industrial Pension Planning", may lead to some form of government intervention and control. The author's long experience in the field of pension planning has convinced him that continual study must be given to this subject based on such non-actuarial factors as changes in business conditions or cost of living, and in his article he describes some of the new ideas in the pension field which are available to management.

Mr. Coate established the pension division of Montreal Trust Company in 1949 and in his present position as manager of the department is responsible for the administration and

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trusteeship of pension funds across Canada with a total asset value of close to $300 million. During World War II he served in Ottawa with the Air Force as Director of Personnel Selection and Manning and for his services was made a Member of the Order of the British Empire. He was formerly supervisor of group insurance for the London Life Insurance Company.

D. F. SIM (page 40)

Donald F. Sim, whose article "Tax Treatment of Patents in Canada" has special significance for accountants who deal with patents, writes from an extensive knowledge of the patent system in this country and the legal and tax aspects of trade marks and copyrights. Because a patent is frequently regarded as a monopoly there is often suspicion and hostility attached to the word, writes Mr. Sim who explains the difference between both and goes on to discuss the principles of taxation as they apply to the sale of patents and to expenses incurred in patent litigation.

Mr. Sim is associated with the legal firm of McCarthy & McCarthy, Toronto. He graduated from Queen's University, Kingston in mechanical engineering in 1949 and from Osgoode Hall as a barrister and solicitor in 1953. He is a Fellow of the Patent and Trade Mark Institute of Canada and a member of the Association of Professional Engineers of Ontario. He serves on the Legislative committee of the Association.

E. R. MAYNERICK, C.A. (page 46)

Year by year businesses grow more complex and competitive; hence the need for faster and more efficient methods for recording information which has resulted in a trend towards greater mechanization through the use of punched card accounting. This

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comparatively new system is coming into more general use, and because many accountants are not too familiar with it, Edward R. Maynerick describes it in "An Introduction to Punched Card Accounting".

Mr. Maynerick was a systems analyst with International Business Machines when he wrote this article but returned recently to enter public practice with the firm of Robert E. Pogue, Toronto. He is a graduate in commerce and finance of the University of Toronto and became a member of the Institute of Chartered Accountants of Ontario in 1957.

EDITORIAL (page 19)

This month's editorial "Principles of Estate Planning" by Lawrence F. Heyding, C.A. points up the complexities of the subject. To do an adequate job today in estate planning involves the harmonious collaboration of the lawyer, accountant, trust officer and life underwriter, and our guest contributor focuses attention on this subject and the reasons for such a development.

Mr. Heyding is a partner in the Toronto office of Peat, Marwick, Mitchell & Co. and since joining the firm in 1954 has devoted his time to tax work. This year marks his twenty-fifth as a member of the profession having been elected to membership in the Institute of Chartered Accountants of Saskatchewan in 1936 and the Institute of Chartered Accountants of Ontario in 1946. He is vice-chairman of the Taxation Committee of the Ontario Institute and a governor of the Canadian Tax Foundation. During World War II he served in Ottawa with the Civil Service Commission, organization division, and was engaged on organization, systems and job classification work.

NOTES AND COMMENTS

New Research Brochure

A special Research Sub-Committee of the Canadian Institute of Chartered Accountants has been working with a representative of the Canadian Bankers' Association on a brochure designed to acquaint bankers, credit grantors and other readers of financial statements with the nature and significance of audit reports. The 40-page booklet "Audit Reports – Their Nature and Significance" has been sent to the chartered banks in Canada for distribution to their managers and supervisors. The brochure is considered to be of sufficient importance to members, particularly those in public practice, that a complimentary copy has been sent also to members of the Canadian Institute, and a French edition will be published shortly.

In addition to detailed explanations of the significance of the wording of the auditor's report, the brochure discusses the nature of the financial statements on which an auditor expresses his opinion, some of the usual procedures used by the auditor in conducting his examination and an outline of other services offered to the business community by the chartered accountant in public practice. Since the brochure is expected to be used extensively as a reference work, a complete subject index has been included along with a list of suggested reference material. Copies of the brochure are available from the Canadian Institute, 69 Bloor St. East, Toronto, at one dollar each.

Francis H. Buck

We deeply regret to announce the death of Francis Harold Buck, registrar of the Institute of Chartered Accountants of Ontario from 1949 until 1959, and at the time of his death a partner in the firm of Peat, Marwick, Mitchell & Co., Toronto. He died December 10 at his home in Toronto.

Born in Port Rowan, Mr. Buck was educated at Ridley College, St. Catharines, and Trinity College, Toronto. He trained with Price Waterhouse & Co., and became a member of the Ontario Institute in 1941. After service with the Army during World War II, he was appointed an associate professor in the Department of Economics, University of Toronto, until joining the Institute in 1949. He was made a Fellow of the Institute in 1953 for distinguished services to the profession.

A man of strong principles and high ideals, he gave dedicated service to the Ontario Institute for over ten years, during which time there was a rapid growth in membership and in the intake of new students. He will be missed by his very many friends in the profession and on their behalf we would like to express our sympathy to his wife and family in their bereavement.

Alberta Institute Seminar

To mark its debut in the field of continuing education for chartered accountants, the Institute of Chartered Accountants of Alberta held a Continuing Education Seminar at the Banff School of Fine Arts from November 7 to 11, 1960 in cooperation with the Department of Extension of the University of Alberta. With the emphasis on topics of interest to members in small and medium-sized practices, the seminar spent one day

each on taxation, the problems of a small practice and cost and management accounting.

SICA Conference

The 1961 conference of the Society of Industrial and Cost Accountants will take place in the Hotel Vancouver, Vancouver, B.C. from June 28 to 30.

Banff Management School

The Universities of Alberta, British Columbia, Manitoba and Saskatchewan are presenting the 12th Seminar of Advanced Management at Banff from January 30 to March 11. This course is offered to executives at the middle to senior management levels with lectures, seminars, role playing and case studies as methods of instruction. Among those on the faculty are Professor J. D. Campbell, C.A., head of the accounting department of the University of Alberta, and Professor Ralph Loffmark, C.A., a member of the faculty of commerce of the University of British Columbia.

American Financial Survey

Stockholders are being treated to more detail and analysis in annual reports than ever before, according to the latest survey of corporate financial reporting practices conducted by the American Institute of Certified Public Accountants. The 14th annual study by the 38,000-member organization has just been published in a book titled "Accounting Trends and Techniques".

The annual report study shows a significant increase in the amount of comparative data and explanatory notes being provided by the nation's publicly-owned industrial corporations.

Examination of 600 annual reports for 1959 showed that 72% of the com-

panies presented all customary financial statements of the current year and prior year side-by-side. This comparison was made in only 48% of the reports surveyed for 1950.

Copies of the book or additional information can be obtained from the American Institute of Certified Public Accountants, 270 Madison Avenue, New York 16, N.Y.

Proposed Merger with Ontario CPA's

On December 20 all members of the Institute of Chartered Accountants of Ontario received a letter explaining a development of outstanding importance to the accounting profession — a proposed merger between the Institute of Chartered Accountants of Ontario and the Certified Public Accountants Association of Ontario. On page 106 we publish in full the letter released by the Institute. Under the proposed merger all members of the C.P.A. Association of Ontario would be eligible as members of the Institute of Chartered Accountants of Ontario, the Ontario C.P.A. designation would be given up, and the merged bodies would be known as The Institute of Chartered Accountants of Ontario. A committee of the Institute will continue to work with a committee of the Association to develop detailed plans and members will be kept informed as these plans emerge.

In a joint statement released by the Institute and the Association, the proposed plan is aimed at raising the standards of the profession in the province and thus ensuring the highest possible standard of service to the public.

Dr. Lucy Morgan

We regret to report that a recent contributor to our Corporate Viewpoint, Dr. Lucy Morgan, has passed away. Dr. Morgan, supervisor of the Economics Division of the Bank of Nova Scotia in Toronto, wrote on "Immigration — Where do we go from here?" (*CCA*, August 1960)

In the News

G. M. BLACK, JR., C.A. (Man.) has been appointed to the Toronto Advisory Board of the Royal Trust Company.

CURRENCY EXCHANGE RATES

The following nominal rates of exchange are supplied by The Canadian Bank of Commerce, International Department, Head Office, Toronto, as at 4 p.m., November 30, 1960:

Australia (pound) 2.21⅛; Belgium (franc) .01979; Denmark (kroner) .1426; France (franc) .2004; Germany (d. mark) .2354; India (rupee) .2076; Italy (lira) .001591; Mexico (peso) .0785; Netherlands (guilder) .2602; New Zealand (pound) 2.75⅜; Norway (kroner) .1378; Sweden (kronor) .1899; Switzerland (franc) .2280; Union of South Africa (pound) 2.76; sterling in Canada, 2.74½-2.75½; sterling in New York, 2.80⅝-2.81⅛; U.S. dollars in Canada, 2¼-2 discount.

CORRESPONDENCE

Edinburgh, Oct. 21, 1960

U.K. More Than English

Sir: I am accustomed to reading with both pleasure and profit various features of *The Canadian Chartered Accountant*. It was therefore with all the more surprise that I read in the September 1960 issue the article "Your Provincial Institute" in the Students Department, beginning on page 245.

In this article the author erroneously uses the expression "U.K." where he should say "England and Wales'. His references to associate and fellow members and the use of the designatory letters "A.C.A." and "F.C.A." apply, as you know, to The Institute of Chartered Accountants in England and Wales only. The Institute of Chartered Accountants of Scotland has only one grade of membership and uses only one designation: C.A.

Incidentally, in an article devoted to the discussion of the designation "C.A.", it seems strange that no mention whatsoever is made of the country of origin and initial date of the designation: Scotland and 1854 respectively!

E. H. V. McDougall,
Secretary,
Institute of Chartered Accountants of Scotland

Vernon, B.C., Nov. 10, 1960

Interest Charges in a Leap Year

Sir: I have recently come across an interesting point where a mortgage amounting to approximately $350,000 is repayable by a blended payment from the first of each month.

Arrangements were made so that the bank could collect the blended payment from the mortgagor for the mortgagee who was a customer at the same bank.

The records were maintained, and no reference was made to the bank figures until one year after the commencement of the payment of the mortgage.

A discrepancy arose between the company records and the bank statement of the payment for the year, and the discrepancy was found to be caused through the fact that the company's records were maintained on the basis of the rate of interest being 6% per annum and, on reference to the bank, it was discovered that the bank referred to interest tables based on 365 days per year. In the period between February and March 1960 the extra day came into the bank's calculation, consequently the difference of $60.00 arose.

The following points appear to the writer:

1. The Bank Act stipulates that a rate of interest not exceeding 6% be charged.
2. Should an adjustment be made, and what could be stated as being a significant amount to warrant an adjustment?
3. The change to the Gregorian calendar had quite an effect on the income tax year end in England, the contention being that the loss of the numbers of days in 1582 would affect landed interests.

I will be interested to hear if any other members have heard of a solution to the manner in which banks charge interest by the day through their tables. The local bank here has referred the matter to its head provincial office for direction.

S. J. Ladyman, C.A.

Montreal, Nov. 4, 1960

Measuring Rate of Return on Capital Investments

Sir: Mr. McArthur's article in the October 1960 issue "Measuring Rate of Return on Capital Investments" was both informative and interesting on recent developments in the theory of capital budgeting.

Few people will dispute the author's contention that this is a complex subject, but there are aspects of it which are simple. One of these is the arithmetic, using compound interest formulae, for linking future benefits to the capital expenditure.

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Some of the articles which he castigates for describing the discounted cash flow method as a simple and correct solution to all capital budgeting problems were solely directed towards familiarization with discounting methods rather than providing a comprehensive appraisal of all aspects of capital budgeting.

Often, one of the greatest hurdles for a company to overcome in the development of capital budgeting is the transition from using return on gross or average investment to using discount or present worth methods based on compound interest formulae. Once this transition has been made, the task of further refining the methods by considering the merits of the various discount and present worth techniques, and problems of re-investment of funds, is a relatively easy one.

Moreover, the Harvard Business School is the first to admit that an ideal solution to an investment proposal can be determined only if all present and future uses of funds are evaluated each time a decision is required. Harvard therefore recognizes that such a scheme may often be impractical. Most companies find it difficult enough to estimate the economics sufficiently precisely for the projects in the forthcoming year. Those three or four years away are often too uncertain to be able to estimate the cash inflow in the succeeding ten years.

In the same issue, Mr. Taylor, writing on "Financial Planning", points out that the discounted cash flow method provides an orderly and useful formula for ranking projects and comparing the return on a single project with the cost of capital. For many companies at this time, the method represents a reasonable compromise between theory and what is practical.

Nevertheless, we are indebted to Mr. McArthur for the information on recent developments in capital budgeting and measuring capital productivity. More articles of this type would be welcome.

C. G. EDGE

Calgary, Oct. 25, 1960

C.A.'s in Public Office

Sir: This letter is written as a passing comment on an editorial (*CCA*, Dec. 1959) contributed by Hon. J. Waldo Monteith, P.C., F.C.A., Minister of National Health and Welfare, wherein he took to task members of our Institute as a whole for their failure to participate actively in politics at its various levels ranging from the civic to the federal field.

The recent civic election in the City of Calgary resulted in the following chartered accountants being elected to office:

Ross Alger — Public School Board
Glenn Holmes — Public School Board
Runo Berglund — City Council

It should be pointed out that Mr. Alger was re-elected for a further term, the other two elected for their first term in public office. In addition, Harvey Bliss, C.A., is a city member of the Public School Board whose term will not expire until next year.

We trust that in some measure this indicates that members of our profession are taking an active and interested part in the conduct of our country's affairs.

R. C. BERGLUND, C.A.

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Editorial

PRINCIPLES OF ESTATE PLANNING

To MANY ACCOUNTANTS estate planning is a comparatively new field of endeavour but one to which, by reason of their training and abilities, they are particularly well suited. A careful and wise plan, well-conceived and soundly implemented not only can provide for the fulfilment of plans of the owner while he is alive but also for the comfort and happiness of his heirs and for a continuation of a business for succeeding generations. This means that, by and large, society as a whole will also benefit. On the other hand, an estate without a plan or one that is poorly conceived and unsoundly implemented can have favourable results only by very good luck.

The starting point of an estate plan is the analysis of the client's financial position and an important part of this analysis is a description and listing of his assets and liabilities. Who is better qualified than the professional accountant to offer valuable assistance in this area in addition to computing estate taxes, succession duties and gift taxes which may be involved in arriving at various estate plans being considered? Frequently, the professional accountant is the only man in the field who is in regular touch with the owner manager of a business. In such cases, where it appears appropriate, he should look upon it as his function to draw to the client's attention the desirability of estate planning and the various possible objectives that should be weighed, and to present all possible alternatives for the accomplishment of the particular objectives that the client emphasizes. Furthermore, his knowledge of the business and the owner's hopes and aspirations for its success uniquely qualify him to assist his client during the planning stage. Because of his unprejudiced position and his skill in the interpretation of financial affairs, the professional accountant is able to render invaluable assistance in the appraisal of various estate planning schemes.

It cannot be too strongly emphasized, however, that estate plan-

ning, if it is to be effective, is a team operation often involving a number of specialists, and the professional accountant should not consider himself qualified to perform all the services required in planning an estate. The services of the legal profession are, for example, essential to the sound development and implementation of any estate plan. The drafting of wills and other legal documents and the selection and interpretation of the various statute and common law provisions which are applicable are functions of the lawyer. Members of the legal profession familiar with trust and family law draw on long experience in dealing intimately with the problems of succeeding generations arising out of the disposition of estates. This involves more than knowledge in the relatively narrow legalistic field — it covers experience in practical family problems as well. For this reason, the professional accountant should consider it as part of his responsibility to impress upon his client the importance of acquiring sound, legal advice in the development of any estate plan.

At one time, estate planning for the average estate owner was relatively simple but times have changed. The multiplicities of complicated tax and other laws as well as the ever-increasing complexities which pervade in business have made it difficult, if not impossible, for one individual to know sufficient about all the possible contingencies to determine how the client's estate can best be planned. In addition to the lawyer and accountant, it may be desirable to consult a trust officer where the services of a trust company may be required. Similarly, the life underwriter should be a member of the team if life insurance is a factor in the picture. The training and experience of the qualified underwriter best equip him to advise on the type of insurance required, so as to give the maximum advantages in terms of immediate liquidity and the minimum disadvantage in added costs.

Recognizing the responsibilities of the profession in the estate planning field, this journal has published during the past year a series of articles on the subject written by members of the legal profession, chartered accountants, and other interested parties. This material is now available as a brochure entitled "Principles of Estate Planning", and it is to be hoped that those who read it will become better acquainted with the estate planning operation and its controlling principles.

Doing Business in Foreign Countries

HAROLD E. CRATE, F.C.A.

THE MORE OBVIOUS channels through which Canadians might be expected to do business in foreign countries are such that much of the incentive disappears because of the chain reaction of successive taxes. For those who are interested in taking advantage of commercial opportunities abroad, there is a compelling need to examine all alternatives in order to find a way to realize, after all taxes, as much of the dollar earned abroad as is possible. The following simple example will illustrate that some surprising variations in the overall incidence of taxes can arise from "doing the same thing in a different way".

Example 1

A small group of Canadians found an opportunity to undertake a profitable real estate development in the United States. It was recognized at the outset that the profits therefrom would be taxable as earned in the United States. The original concept of the U.S. attorneys was to incorporate a company in the United States which would pay the taxes called for by the Revenue Code and then distribute the remainder as dividends to the Canadian shareholders. On the assumption that the profits were $1,000,000 the following taxes and net proceeds would flow from this procedure:

Net profits	1,000,000
U.S. corporate taxes	520,000
Balance as dividends to Canadians	480,000
Personal Canadian taxes on dividends, say 50%	240,000
Balance of available profits	240,000
	or 24%

(If U.S. withholding tax is fully offset)

The alternative adopted was to form a Canadian corporation which would operate in the United States as a branch. The overall taxes then work out somewhat as follows:

Net profits		1,000,000
U.S. taxes		520,000
Balance of profits in hands of Canadian company		480,000
Tax on distribution to Canadians $240,000 as dividend at 50% less 20% dividend credit	72,000	
$240,000 at 15% as stock dividend	36,000	108,000
Balance of available profits		372,000
		or 37.2%

(Difference in overall tax $132,000)

Substance of an address at the Income Tax Seminar, Queens University, May 1960.

The following illustrations demonstrate some uses to which the "tax shelter" countries might be put.

Example 2

A Canadian company does much of its manufacturing in the United States through a subsidiary there. In the past this subsidiary has done a considerable export trade with European customers, but this export trade is now impaired by the Customs Union and the Outer Seven Union which have recently come into operation. The company has arranged for a factory to be built in Europe, inside the Customs Union, which will be owned by Europeans but will pay a royalty on production to the Canadian owners of the patents and processes. Little of this royalty will accrue to the benefit of the Canadian company and its shareholders if the full impact of all intervening taxes is deducted, i.e. European withholding tax, Canadian corporation taxes, shareholders' dividend taxes, etc.

The alternative would seem to be to form a company in a tax-haven country such as The Bahamas to which the Canadian company would cede its European rights in exchange for capital stock. The royalty agreement would then be made with the European factory by the Bahamian company. Royalties would be received in The Bahamas tax free, except for the tax withheld in Europe, and would then be declared as a dividend to the Canadian parent which would be received tax free under section 28(1) of the Income Tax Act.

Obviously the use of tax havens or "base" countries, as they are called in the United States, is a very individividual thing, each case being tailored to a different set of circumstances. Consider the following example.

Example 3

A Canadian oil company buys several million barrels of oil each year on the world market. This is done through brokers, and a recognized brokerage fee per barrel is paid. It appeared feasible to form its own brokerage company in a haven country which carried out this function. The brokerage profits then accumulate tax free and can be either transferred to the Canadian parent company as dividends which would be exempt on receipt or used for financing further offshore enterprises.

Applicable Tax Laws

These examples indicate briefly some of the things which might be accomplished. Here is the detail of the tax laws which make these possible.

One of the basic policies of Canadian income tax law is that all residents of Canada are taxed on their income from all sources, in other words, on their world income. In addition, non-residents of Canada are taxed on the income earned by them in Canada. These basic concepts are contained in sections 2 and 3 of the Income Tax Act.

Other sections of the Act then give special limited exceptions to these general rules and may give complete exemption from Canadian taxes on some foreign income, or give relief from foreign taxes paid on foreign income. Section 28(1) provides, among other things, that a dividend received by a resident company may be deducted from income in arriving at taxable income if it is received from a non-resident corporation of which more than 25% of the issued capital stock belongs to the receiving corporation. Section 41 provides that a taxpayer who is resident in Canada

may claim a deduction from his Canadian tax in respect of income taxes paid by him to another country.

This article is necessarily limited to the tax problems of corporations and is not concerned with the problems of individuals, which can also be quite complicated. At this point, it might be as well to distinguish between a non-resident and a resident corporation. Some countries, such as the United States, consider that all companies incorporated therein are resident companies for tax purposes. This is not the case in Canada. We have to fall back on the legal interpretation of residence, which in turn relies to a great extent on the precedents in English case law.

Generally, a company is resident for tax purposes where its main business is carried on, and it has been held that its main business is carried on where its central control and management is located. (*Egyptian Delta Land & Investment Co. Ltd.* v. *Todd*). Central control and management are normally located where the board of directors meet and make the decisions governing the day-to-day activities of the company. A decision handed down by the House of Lords in 1959 (*Unit Construction Co. Ltd.* v. *Bullock*) laid down another criterion for deciding corporate residence: that residence will be where the management is, even though the directors meet elsewhere, but do not in fact manage. In other words, even though the directors of a company are meeting outside of Canada, but the management decisions are actually being made in Canada, the non-residence status could be lost. It is interesting to note that a company may be resident at more than one place at the same time. This situation could arise where the central control and management was sufficiently divided between two places.

Word of Warning

It is possible then to have a company incorporated in Canada but classified as a non-resident for tax purposes. Perhaps a word of warning is appropriate at this point. The English rules regarding residence should not be relied on too heavily if one is entering into irrevocable transactions. The Governor-in-Council already has power under section 108(9) of the Canadian Act to make special regulations regarding residence for the purpose of withholding taxes, and it is possible that the Income Tax Act could be amended at any time to include special rules for residence.

The withholding taxes have already been mentioned briefly. Section 106 of the Income Tax Act requires a 15% withholding tax at source on payments by residents of Canada to non-residents of dividends, interest, rents, royalties, etc., with certain specified exceptions. For instance, interest payable in a foreign currency, calculated by reference to the foreign currency and paid to a non-resident person with whom the payee is dealing at arm's length, is tax free as far as withholding taxes are concerned. Dividends paid to a non-resident parent company are subject to 15% withholding tax, but if the subsidiary is wholly owned, the tax is reduced to 5%, except in certain unusual cases. It is necessary, of course, to refer to the international tax agreements whenever arrangements have been made with a corporation in a country with whom a reciprocal agreement has been made. These agreements quite often vary the rules of withholding taxes.

The Canada-U.S. tax agreement

provides that ordinarily no tax in excess of 5% need be withheld from dividends paid by a Canadian corporation to a corporation organized under the laws of the U.S., provided that during the whole of the taxation year at least 51% of the voting stock of the Canadian company was owned by the U.S. corporation. The U.K. tax agreement provides that ordinarily no tax need be withheld from a dividend paid by a wholly-owned Canadian subsidiary to a parent company resident in the U.K.

So much for the pertinent Canadian legislation. In looking at some foreign countries, it might be useful to break them into categories based on the ways in which they tax resident companies, particularly on the operations outside the country or profits obtained outside the country. In the book "Tax Factors in Basing International Business Abroad" by William J. Gibbons (published by Harvard University) base countries, that is countries from which foreign operations can be carried out, are divided into three general categories as follows:

1. Countries which do not levy any income tax at all. Examples of such utopias of the modern world are Bermuda and The Bahamas.
2. Countries which do not levy any income tax upon holding companies, such as Luxemburg, Switzerland and Lichtenstein. Switzerland and Lichtenstein have a withholding tax on dividends paid by holding companies.
3. Countries which exempt the foreign income of domestic corporations from income taxation, such as Haiti, Venezuela, Liberia and Panama. Haiti, however, imposes a withholding tax on dividends paid to non-residents. Uruguay gives exemption from income tax to corporations meeting certain special requirements.

It is interesting to note that in other countries, particularly the U.S., Canada is considered to be a base country in the third classification, since it offers exemption from tax on foreign income in certain circumstances.

To show the types of opportunities which are available, it may help to deal in a little more detail with the tax climates of The Bahamas, Panama and Liberia.

The Bahamas

In this self-governing British colony, there are no personal or corporate taxes of any kind, either on domestic or overseas earnings. In addition, there are no capital taxes, dividend taxes, sales taxes or capital gains taxes. The revenue is derived almost completely from import duties, stamp duties, a small real property tax and a small probate duty of 4%. There is virtually free convertibility of exchange to dollars or other hard currencies for non-residents, and generally repatriation of dollars can be arranged at the exchange control with ease. The Grand Bahamas (where a freeport is situated) encourage the introduction of foreign industry by offering contractual exemption from income tax of up to 30 years and exemption from excise taxes and customs duties of up to 99 years, except for goods used for personal consumption.

Other advantages are that documents do not need to be translated into a foreign language, and the law is based on the common law of England.

Panama

Panama has taxed the income of corporations and individuals for about

20 years; the rates of tax go as high as 34% with an additional surtax of 20% on all income which is not derived directly from human labour. However, income received by a Panamanian corporation from sources outside the country is specifically exempt from taxes, including withholding taxes. Income is deemed by the Panamanian government to arise at the physical location of the goods or assets producing income. It has been held that substantial management activity in Panama cannot give rise to a source of income. Thus, management of operations outside of the country would not give rise to taxation in Panama.

The articles of incorporation of a Panamanian company may be prepared in any language. There are no exchange restrictions and the balboa is generally regarded as a stable currency. There are excellent ports in Panama, and plentiful intelligent and relatively cheap labour.

Liberia

This small republic on the West Coast of Africa levies an income tax on corporations which ranges from 5% on net income of $5,000 to 25% on net income over $50,000. However, it levies absolutely no taxes on income derived from sources outside of Liberia if the corporation is controlled by non-residents or resident aliens, in other words, by persons who are not Liberian citizens.

There is no requirement for filing periodic financial or operating reports, but it is understood that a list of shareholders must be available. This latter requirement is not present in all countries, for instance, in Lichtenstein. There are no exchange difficulties in Liberia, because the monetary unit is the American dollar. There are no withholding taxes, and incorporation of companies can be effected easily.

Forms of Corporation

After this brief review of some of the principles of taxation in Canada and overseas, we can now consider the methods of doing business in other countries, with emphasis on the tax position under each method. The following are the main forms of organization through which business can be carried on outside of Canada:

1. A subsidiary company incorporated in the country in which business is to be done.
2. A subsidiary company incorporated in Canada with management situated outside the country, in other words, a non-resident Canadian corporation.
3. A branch of a Canadian company.
4. A subsidiary company incorporated in a foreign country, carrying on business in still another country through a subsidiary company or branch.

A foreign subsidiary would be subject to any income tax levied in the country of operation. However, any dividends paid to the parent company would be received free of tax under section 28(1)(d) of the Income Tax Act which we mentioned earlier. It is important to note that any dividends paid by a foreign subsidiary can be subject to a withholding tax such as the 5% tax which would normally have to be withheld by a U.S. subsidiary of a Canadian company. This withholding tax in some non-treaty countries could greatly exceed the rate of 5% and rise up to 30% in certain cases. Therefore, even though section 28(1)(d) allows the dividend to flow free of Canadian tax, there is no relief from withholding tax in the foreign country.

The foreign tax credit mentioned earlier can only be claimed when the amounts upon which the foreign tax is paid are included in taxable income. However, the Canadian tax laws are such that through the use of a subsidiary company, full advantage can usually be taken of tax incentives offered in other countries.

The effect of having operations carried on through a non-resident Canadian corporation are similar to those of having a foreign subsidiary. The residence of a company is necessarily artificial, and care should be taken to establish residence, bearing in mind the criteria mentioned earlier. In countries like Spain, which do not permit domestic corporations unless the control of shares is in the hands of Spaniards, the Canadian non-resident company may be the way to get the benefit of both the low Spanish tax rate and the provisions of section 28(1)(d).

Where a branch is operated in a foreign country, it is usually taxable in that country on the profits deemed to have been earned by the branch. The parent company can then claim a foreign tax credit to alleviate the tax paid in the foreign country. If the rate of tax in the foreign country is low in comparison to the Canadian tax rate, the credit will probably result in all of the foreign taxes paid being allowed as a credit. Where the preliminary operations in a foreign country are expected to result in a loss, it might be beneficial to operate as a branch until the losses have been offset against future profits in the country of operation, and then incorporate a company. In this way the early losses can also be used to reduce Canadian taxes since the loss in the branch would reduce the overall taxable profits of the company. A further advantage of a branch operation is that profits are not subject to withholding taxes on transfer to the head office, except in certain countries such as Australia. On the other hand, where the foreign country has a favourable tax climate by way of tax exemptions, low tax rates, or high depreciation allowances, a branch operation cannot take advantage of them since all profits are taxed in Canada, subject to the foreign tax credit, which is limited to the foreign tax paid.

Finally, we come to the form of organization where a foreign subsidiary carries on business in still another foreign country through a subsidiary or branch. Some countries, such as the United States, rely mainly on the foreign tax credit provisions alone to protect residents from double international taxation. In the case of direct investment through a subsidiary in a foreign country offering tax incentives, any dividends to a parent company, say in the U.S., would normally be taxed at full corporate rates, with some relief for any tax paid in the foreign country. In other words, no advantages can be taken of the low tax rates, etc., which are offered in the foreign country in the absence of provisions similar to our section 28(1)(d), exempting dividends from foreign subsidiaries from tax. These circumstances have led to the popularity of the incorporation of a third company in a tax sheltered company where no tax is imposed on income from foreign sources. This company is a subsidiary of the parent and owns the shares of the operating foreign company and could operate through a branch. In this way profits from countries levying no income tax, or comparatively low income tax, can be accumulated and used for further

foreign investment, without the incidence of any tax in the country of ownership.

The provisions of the Canadian Income Tax Act resulting in the total tax exemption of a foreign dividend income from controlled companies make the use of a third company tax haven less attractive to Canadians. However, it may be that because a particular country has more favourable tax agreements with other countries than our country has, it would be beneficial to have an intermediary subsidiary in such a country to operate in the third country. This situation can be particularly advantageous if the ultimate aim is to sell the shares of the company incorporated in the tax haven country.

Look at the Long Term

These, then, are the main of countless ways of organizing business to take full advantage of the tax relief available. For instance, wherever bona fide functions can be carried out abroad in connection with the export or import of goods from or to Canada, it might be worthwhile having a company established in a tax haven country, such as The Bahamas, to carry out these functions, and accumulate some tax-free profits. Some of these functions might be as export or import agents, commodity brokers, research or material testing laboratories, etc. Again there could be advantages in having patent rights owned by a company resident outside of Canada.

It is important that the management decisions to commence foreign operations should be based on the long-term expectations as to the profitability of the enterprise and the political and economic stability and development of the country rather than on the vagaries of taxation policy. In addition, before taking any important steps toward forming a foreign enterprise, information regarding the latest legal and tax position in the particular country should be obtained.

This article is only intended as an introduction to a subject which will become more and more important as international transportation facilities improve and foreign markets become even more competitive.

So Say We All

The following letter, quoted in *Taxation* for April 30, 1960, comes from a report of the Commissioner of Taxes for Rhodesia and Nyasaland. It was written by an African on receipt of an income tax return, and expresses with beautiful simplicity exactly what we have felt about the thing for years.

"I have to refer to the attached form dated July 19, 1959. I regret to state I am unable to complete the form as I do not know what is meant by filling this form – moreover I am not interested in this income services. Could you please cancel out my name in your books as this system has upseted my mind and I do not know who register me as one of your customers in this matter."

—*Canadian Tax Journal,* September - October, 1960

The Lawyer in Estate Planning

R. deWOLFE MACKAY, Q.C.

It is perhaps an over-simplification and a self-evident statement to say that a knowledge of law is inherent and basic in all estate planning. This does not mean that lawyers are alone qualified to plan estates, but it does infer that a trained legal mind should at all stages be consulted in matters of estate planning.

There are so many facets to estate planning that no one profession or expert can arrogate to itself or himself the exclusive right to plan estates, but all need to cooperate if the best interests of the person involved are to be served. The non-legal expert, in fact, ignores the legal profession at his own risk since, of course, the legal profession in each province is protected by statutory prohibition against the invasion of its field. The lawyer, by the same token, advises his client on matters of estate planning at his own risk if he ignores the experience and special knowledge of the expert in estate planning.

What, then, are the legal aspects of estate planning and how essential is a knowledge of law and a legal training to proper estate planning?

First of all, there are, of course, the statutory enactments that have some bearing on estate planning; there is also in Quebec the Civil Code, and in each of the other provinces various and sundry statutes touching on various aspects of the civil status of persons resident and domiciled in the respective jurisdictions; there are the Companies Act of Canada and the Companies Acts of the various provinces; there are the insurance laws, both of Canada and of the different provinces, and probably many other statutes which in the course of estate planning would have to be considered; and there are, of course, the taxing statutes—the Estate Tax Act of Canada, the Succession Duties Acts of the various provinces, the Income Tax Acts of Canada and the Province of Quebec. Statutes of special application, of course, can be read and their provisions interpreted by lawyers, but the non-legal expert derives a fundamental knowledge of the operations and administration in his own field of certain of the various statutes which are involved in estate planning, and his experience in their application entitles him to claim equal, if not in some sense superior, rights to interpret such special statutes. The effect of estate tax, succession duties and income tax on estate planning is, however, a field all its own but can hardly be said to be the exclusive field of the lawyer, although the lawyer, in his role as adviser to

anyone planning his estate, should not be ignored where these taxing statutes are involved.

There is, however, the vast field of common law in the common-law provinces (whether reduced to statutory form or derived from long-standing precedents) and the equally all-embracing field of civil law derived from the interpretation of the Civil Code of the Province of Quebec, a great number of whose articles have their origin in the common law but the majority of which differ in many aspects from it. It is fair to state that in this field the trained legal mind alone is capable of interpreting the scope and the application of these common or civil laws which are fundamental and must be understood before an estate may be planned properly.

General Aspects

Estate planning must take into account the things that a man may do during his active lifetime, when he has many years of useful life to go. Some steps he can take immediately to divest himself of his assets in whole or in part, present and future. In so doing, however, the individual must have due regard for the days of his retirement, to ensure that he has sufficient to live a comfortable old age out of income whether by way of revenues from the remainder of his assets, or from pensions or old-age retirement benefits or by amortization of his remaining capital assets.

The residue of his assets must then so be settled by his will that, together with settlements made during his lifetime, the individual will ensure that his intentions are made effective. Also the estate must be so planned as to see that the immediate beneficiaries are not deprived of the real benefit for the sake of the ultimate benefit of the second and third generations.

All too often the attempt to avoid or reduce estate taxes and succession duties is made so paramount in estate planning that the real intentions of the individual are distorted, and those whom he wishes to benefit very often are deprived of the benefits intended and those who are only of secondary interest receive benefits greater than were intended. The real purpose of the estate plan, that is to say, the ultimate benefit of the dependents, is often frustrated, and in addition the law might be changed, catching up with all attempts to avoid or minimize tax.

Domicile

It is essential that the individual's domicile be clearly established for it is the law of that domicile that governs all the transactions which he may effect in the formation of a plan. Succession duties and estate taxes also are imposed on the basis of domicile at death.

A man's domicile is not always too easy to determine, especially if he is living in a jurisdiction other than that of his birth. A man's domicile of origin (although the term is really a common-law and not a civil-law term) is usually the place where his parents were domiciled at the time of his birth, under common law, and the place where his parents were domiciled at the date of his majority or emancipation, under Quebec civil law. Although the domicile of origin under the common law is more difficult to change than is the case under the civil law of Quebec, a man's domicile of origin is not easily changed under either law. To people

born outside the Province of Quebec but living in the Province of Quebec (and there are many such people), and to people born in the Province of Quebec but living outside of the Province of Quebec (and there are also many such people), this is a most important problem, since the laws of Quebec in matters of civil status are in many instances very different from those of the common law of the other provinces. Succession duties and estate taxes also are imposed on the basis of domicile at death.

Marital Status

A man's marital status, for example, is determined by his domicile at the time of his marriage and not by the place of solemnization of his marriage. If a man's domicile at the time of his marriage is in Quebec, his marital status as determined by the laws of Quebec follows him into every jurisdiction in which he may later acquire residence, or for that matter domicile, (except possibly where real property rights are concerned, since such real property rights are normally governed by the jurisdiction where the real property is located).

If a man's marital domicile is in the Province of Quebec, several consequences follow that differ from the consequences that flow from the common law of the other provinces.

For example, unless the intended spouses have entered into a pre-nuptial marriage contract specifying that they shall be separate as to property in accordance with the rules normally applicable in common-law provinces, the spouses are subject to the regime of community of property until the community is dissolved, either by death of one of the spouses or by court order. An important consideration is the fact that on the death of either spouse the survivor is entitled by law to one-half of the community assets, and the deceased cannot by his will dispose of more than one-half of such assets. The intended spouses, on the other hand, could have entered into a pre-nuptial marriage contract providing that they would be separate as to property, in which case such marriage contract remains binding and cannot be changed by the parties after their marriage.

Any estate planning, therefore, that is to be considered must take into account the marital status of the individual concerned and the terms of the marriage contract, if any.

A second consequence that flows from the marital status of the individual concerned being that of the Province of Quebec is that gifts between husband and wife (excepting normal gifts which the husband, having regard to his financial status, may from time to time give to his wife on the occasion of Christmas, birthdays and other similar anniversaries) are prohibited; in addition, a wife is prohibited from binding herself with or for her husband or from guaranteeing his debts or giving any other form of surety (except to the extent of the community assets if their status is under the regime of community of property).

There are two exceptions to the prohibition against gifts made between husband and wife. One is that gifts may be made by pre-nuptial contract, and such gifts may be either absolute or conditional and may be made to take effect during the lifetime or after the death of one of the spouses. The second exception is that a man is entitled to insure his life in

favour of his wife, but not the reverse.

Special Rules

If a man's marital status is governed by the laws of the Province of Quebec, the putting of a home in the name of his wife is ineffective for all purposes of succession. Furthermore, it is questionable whether such action would in such circumstances be effective for estate tax or succession duty purposes even though it constituted a valid gift to his wife under pre-nuptial contract and was made outside of the three and five-year limitations of the Estate Tax Act and existing provincial Succession Duty Acts.

The same rules apply to the case where a husband, during his lifetime, may have built up his wife's assets by putting securities in his wife's name from time to time. Apart altogether from the income tax implications of such actions, the wife is always faced on the death of her husband with the question as to whether securities registered in her name are the result of gifts that are prohibited by the Civil Code, in which case they might be disregarded not only for purposes of succession and inheritance but for estate tax and succession duty purposes.

The income tax implications add to the complexity of the problem. Where community of property is involved, in given circumstances, securities or other property registered in the name of the wife could come from four different sources: (1) the investment of the property which she had prior to her marriage or which she received by way of gift or will from her parents or by bequest under the terms of which the property bequeathed was to remain her own personal property; (2) the income derived from such bequeathed property; (3) the investment of assets which form part of the community and which the husband has put in his wife's name; (4), as above mentioned, securities which the husband has purchased out of his own private property and which he has placed in his wife's name. There are also questions as to whether the income on securities purchased by the wife out of the income from her own private property may not have to be reported by the husband and added to his income.

One of the gifts that a husband may make to his wife is the insuring of his life in her favour. Once, however, an individual takes out a life insurance policy naming his wife as beneficiary, under the laws of the Province of Quebec, there are certain restrictions to his disposal of that policy. He cannot, for example, name a replacement beneficiary other than his children, and he cannot use the policy as a guarantee for his debts even with the consent of his wife. It follows as a consequence that, to the extent that life insurance is involved in estate planning, the special laws of Quebec respecting the civil rights of the parties, as well as the Quebec insurance laws, must be carefully scrutinized if the individual whose estate is being planned is subject to the marital law of that province, whether living or residing or even being domiciled outside the province of Quebec at the time of his death.

Gifts and Trusts

Under the laws of the Province of Quebec, gifts *inter vivos*, whether made directly or in trust, must follow certain formalities if they are to be effective. Here again, estate planning

must take into careful consideration the domicile and the marital status of the donor who proposes to make gifts or set up trusts for his wife, children or other dependents, as part of his estate planning.

With regard to trusts, while the articles of the Civil Code of the Province of Quebec dealing with trusts had their origin in the common law of trusts, they differ in quite material aspects. It would serve no useful purpose to discuss these differences in this article, other than to point out that such differences do exist and must be taken into account. It might be noted here, however, that under the Quebec Succession Duty Act if a gift is made in trust, even if irrevocable and unreserved, the value thereof at the date of the donor's death is added to the estate of the donor for the purposes of succession duties.

Inheritance, Successions and Wills

Under the laws of Quebec, an individual has the complete freedom of disposing of his assets by will (including his share in any community of property). If an individual dies intestate (without leaving a will) or if in his will he fails to confirm gifts made during his lifetime, his heirs or legatees, as the case may be, can be faced with the necessity of returning to the mass of the estate any gifts made by the deceased during his lifetime.

Part of estate planning must therefore include not only the making of gifts *inter vivos,* either directly or in trust but also appropriate provisions in the will to see that these gifts *inter vivos* and by trust are not frustrated on the death of the testator.

Corporate Devices

Estate planning, of course, is not only concerned with the immediate or eventual disposition of an individual's accumulated wealth, but also with the disposal of future accretions or accretions anticipated at the time the estate is being planned. If an outright gift of property is made, it is obvious that the income from such property or the accretions or capital gains derived therefrom are for the exclusive benefit of the donee. If, however, the gift is by way of a trust which is revocable or the income is reserved by the donor in trust, both the Estate Tax Act and the Succession Duty Acts of the provinces involved bring back into the estate of the deceased for tax and duty purposes the value of the trust at the date of death (and this is also true for Quebec succession duty purposes even if there is no reservation of income and the trust is irrevocable).

Estate planning, therefore, also must take into consideration the use of corporate set-ups as a device for transferring property for all purposes of law as well as for avoidance or reduction of estate tax or succession duties.

Needless to say, a man who uses the corporate device in planning his estate, so that he "freezes" his interest in his assets, business and undertaking, may not necessarily at the same time wish to give up effective control of his business but to retain for himself the right to regain control of his business should his wife or any of the children whom he wishes to benefit not be interested in or capable of carrying on the business and undertaking. In that case he must take into account not only company law but the civil law affecting his civil status.

For example, a man who may part with only a portion of his business

may nonetheless need the security of the business transferred to his wife through the incorporation of one or more companies, but he would (if his marital domicile is in Quebec) be faced with the law of Quebec which, as aforementioned, prohibits a wife directly or indirectly binding herself with or for her husband. Consequently, a wife who is the owner of the equity shares of a company that operates part of the family business is incapable of pledging those shares as security for or guarantee of the debts of her husband, or possibly even the debts of her husband's company.

Then, too, if a father (whose domicile is in Quebec) transfers, through the incorporation of companies, the whole or any part of his business to one or more of his children, any equity or other shares which such children might hold could not be sold by such children so long as they remained minors (in most cases until they have attained the age of 21) excepting after the convocation of a family council, the appointment of a tutor other than the father and the approval of the court to the sale of the shares, and then only by public auction.

Furthermore, even if an individual effectively causes the corporation controlled by him to transfer assets to a company incorporated by or for his wife or children and such individual has no effective control over the second company, the Quebec succession duty authorities will seek to add back the value of the assets of such second company to his estate on his death and at the valuation thereof at the time of his death.

Pension and Death Benefits

It is of course necessary also for salaried officers and employees of public companies to consider and plan carefully their respective estates and they must take into account in the estate planning the effect of employment benefits.

In this field also there is scope for differentiation between the laws of Quebec and the laws of other provinces. For example, a great many of the employee pension and benefit plans provide for the designation by the employee of the dependent who is to obtain the death benefit provisions of any such plan. There is still in the Province of Quebec considerable argument as to whether or not the designation of such dependent by the employee is legal and valid, or whether it constitutes an unauthorized disposition of property and rights on death otherwise than by will and, in the case where the wife of the officer or employee is so designated, whether it constitutes a gift between husband and wife prohibited by the Civil Code of the Province of Quebec.

There is, too, always the question as to whether or not, in any given plan, the beneficiary of a death benefit has a legal right of action against the company to claim the benefits of the plan of which he or she was the beneficiary designated by the employee.

There is also the question as to whether or not the indemnity under an accident and sickness policy payable in the event of death constitutes life insurance benefits which are for estate tax and succession duty purposes included in the aggregate estate, subject to tax or duty as the case may be.

These and other similar problems arising out of employee benefit plans must be considered in an overall estate plan.

Conclusion

Although unquestionably the expert or experienced tax planner, whether legal or non-legal, is competent to set out an estate plan that will serve the individual for whom he is acting, it is most desirable if not essential that the advice of a trained legal mind should be obtained at all stages of estate planning. Both the professional adviser and the expert should be astute enough to seek each other's advice so as to apply their combined experience to the best interests of the person who is seeking to plan his estate and to provide for himself and his dependents the best protection possible.

Walter J. Macdonald Memorial Award

An announcement appeared last month in connection with the Walter J. Macdonald Memorial Award to be given annually for the best article written by a member of the Canadian Institute of Chartered Accountants and published in *The Canadian Chartered Accountant* during the year. The award, judged by a panel of three to be appointed annually by the president of the Canadian Institute of Chartered Accountants, carries an honorarium of $500 together with a tangible token.

For the year 1961-1962 articles published from August 1961 to June 1962 inclusive will be eligible. In subsequent years the award will cover the period from July to June. The judges will use the same criteria that the Editorial Board employs in selecting manuscripts for publication: (1) interest to chartered accountants, (2) contribution to knowledge and (3) clarity of style. If, in the majority opinion of the judges, no entry in any year is considered worthy of the award, an honorarium will not be made for that year.

The offer of the award was made last September at the 58th annual conference of the Canadian Institute of Chartered Accountants by Deloitte, Plender, Haskins & Sells in memory of the late Walter J. Macdonald, F.C.A., senior partner of the firm, and was accepted at that time by the Executive and Council of the Institute.

New Developments in Industrial Pension Planning

J. FRASER COATE

SINCE SO MANY new trends in pension planning have developed in the past five years, now is an appropriate time to review these developments in the light of past experience and future expectations.

Inadequate Benefits

While the question of adequacy of pension benefits is perhaps not particularly new, it seems to have been recognized more specifically in recent years.

If there is an "average" industrial plan in Canada, its benefit is in the order of 1% for past service with 1½% of current salary for each year of current service. The employee contributes 5%, and the employer assumes the full cost of the past service, plus the difference between the employees' 5% and the total required to fund current service each year.

If today's salary scale had been in effect 20, 15 or even 10 years ago, this formula would have produced a most adequate industrial pension. Whether we dislike the overworked term "inflation" or not, the fact remains that today's cost of living and scale of living differ considerably from those of the past. As a result, a great many firms are finding that current pensions are simply not adequate, and are providing from their current payroll supplementary benefits related to final pay. That this is an undesirable and perhaps even dangerous practice will generally be agreed.

In the first place, the pensioner has no assurance either through the funding of the liability or from present or future management that the practice will be continued. Secondly, as more and more employees are pensioned, an ever-increasing non-productive payroll liability is created which does not show up on the balance sheet. Moreover, as it can hardly be established that all of these retired employees are retained as consultants, it may be questioned that a provision exists under income tax regulations to justify such an expense item. Finally, the opportunity for discrimination abounds where supplements are awarded individually and continue at the grace of the employer.

Solution for Today

Admittedly, one good answer to the problem is to amend the plan from a unit benefit based on career or average salary to a unit benefit based on the average of the last five or ten years, or perhaps of the best five

years, depending on the type of business and employment. Although this provides a neat and ready solution, it is a responsibility which many business and industrial officers hesitate to accept for themselves or to load on the shoulders of their successors.

To attain adequacy in another fashion, a number of plans have been, or are now, in the process of updating past service benefits. For the majority, relating past service to current salary will provide the desirable effect in the foreseeable future which would not be created by an improvement in the current service percentage.

Under the new regulations, past service liabilities are no longer restricted to tax credit over a minimum of ten years, nor is there any maximum period other than the actuarial, usually 30 years. Past service funding, therefore, is flexible. In a good profit year, all or a good part may be paid off; in less profitable years, the interest on the unfunded position is the only liability.

Supplementary Contributions

At some point, Canada must decide whether it is headed towards a completely socialistic state or whether it has now gone far enough. Certainly it does not lag far behind any country in government-provided benefits. In the field of hospitalization and family allowances, it is ahead of most.

Whether Canadians will look for still more from the government in the field of pensions or prefer the practices of free enterprise will depend, to a great extent, on industrial and business leadership.

No non-contributory pension plan and few average earnings contributory plans will provide in themselves a completely adequate retirement income. We must look for ways of strengthening private pensions; otherwise, we invite government intervention.

Our tax provisions provide for exemptions on employee contributions, which is not the case in the United States. It is suggested that all plans should permit and indeed encourage additional contributions over and above the required rate.

Not only are the capital and the interest yield on this personal savings and investment plan tax exempt, but also the effect of compound interest is an advantage not offered in most other forms of long-term saving. Whether the employee is credited with interest at an actuarially assumed rate or at the actual yield on the fund, he is assured of a better yield than is normally otherwise available.

If, for some reason, it is not practicable or feasible to provide for additional contributions as a part of the plan, arrangements may be made for salary deductions of a contribution up to the amount of 10% of salary less the required amount to the plan up to the maximum of $1,500 per year, to be paid into a registered retirement income plan.

Portability

There can be no doubt that in the near future the right of portability, i.e., the right to transfer tax-exempted accumulated dollars from the pension fund of employer "A" to employer "B", will receive a considerable amount of attention and possibly government intervention.

The basic problem of portability does not pertain to the transfer of employee dollars, but rather to those contributed by the employer. Because

the original purpose of a pension plan was to retire employees after long and faithful service, in most plans the vesting, i.e., the right of the employee to company dollars, is not complete until after 15 or 20 years.

Even after being fully vested, if the employee leaves, he is usually given the option of a cash return of his own contributions or a paid-up pension provided by his contribution plus company dollars at normal retirement date. Regrettably, when given this option, most severing employees take the cash. Whether this practice can be discouraged by some further tax legislation is a nice question.

As the employee normally is leaving either by his own choice or for just cause, the employer has no particular reason for wishing to have the responsibility of maintaining the individual account from the time of severance until normal retirement date.

If, however, employer "A" agreed to transfer the whole of the individual's vested dollars to employer "B", employer "A" would lose the mortality credit, that is, the amount credited to the fund from those dying before retirement. This may amount to as much as 20% He is also going to lose the amount of excess interest earned over the actuarial assumption.

One practice still not widely followed provides a solution. The first employer, on actuarial certification, may deduct the mortality assumption before transferring assets to the second.

Aside from this, present regulations provide that dollar credits may be transferred directly between funds without tax liability. Lacking the acceptance of the new employer, the dollars may be transferred to a registered retirement savings plan. All transfers of credits should be considered in terms of the reserve or dollars behind the benefit rather than an amount of pension benefit.

Whether or not provincial regulations will one day be established concerning vesting and portability remains to be seen. One wonders how a company which has voluntarily established a pension plan can be regulated into a more costly vesting provision unless the regulations also provide that his competitor down the street who does not have a plan at all must establish one on a comparable basis.

Variable Annuities

Variable annuities have now passed the theoretical stage, and to the extent that some five years can be called experience, they seem to have become established as a valuable tool in planning for adequate pensions.

While so far, to our knowledge, only a handful have been registered in Canada, in the United States some 20 or more of good size have been implemented.

It is interesting to note, however, that in no case to date does the complete plan consist solely of a variable annuity. Either 50% of the contributions go to a fixed dollar plan, or, as is the case with Airline Pilots Association plans, the variable annuity goes on top of the basic plan provided for all employees of the airline.

In principle, it is projected that if the purchasing power of the fixed dollar benefit lessens, the variable annuity benefit will increase.

To accomplish this purpose, all investments for the variable portion are made in common stocks. The participant earns a pension consisting of benefit units rather than benefit dol-

lars. If the value of the common stock unit increases during the accumulation period, it is expected that the variable annuity portion of his total benefit will be somewhat more than his fixed dollar benefit.

It has the further objective that if and as the unit values continue to increase after retirement, so will his pension dollar payment increase. If, on the other hand, they decrease, theoretically the purchasing power of his fixed income benefit portion will increase.

We question that variable annuities will ever be quite as popular in Canada as they may be in the United States. The following will illustrate some of the problems of the Canadian trustee compared with the U.S. trustee:

1. The Canadian trustee does not have as broad a base and diversification of Canadian stocks available.
2. Due to the 20% tax credit on dividends received by the tax-paying Canadian common stock owner, the non-taxable pension fund does not receive equivalent value on the investment.
3. If the Canadian trustee purchases U.S. stocks, he is concerned about the variation in exchange rates which, over the years, has been as much as 20%.
4. Dividends on U.S. stocks are subject to 15% withholding tax with no offsetting Canadian tax against which to apply it.

Place of Common Stocks

Despite the foregoing negative factors, common stocks very definitely have a place in pension fund investment portfolios in Canada.

In the United States it is not unusual that the larger funds have a proportion as high as 50% in equity investment. It is felt in Canada, in view of the factors discussed, plus the fact that bond yields are somewhat higher, that the equivalent proportion is in the neighbourhood of 30%.

Some consideration in planning investment policy must be given to the type of plan and the benefits provided.

As money purchase plans are practically outmoded, they need not be considered seriously. Suffice it to say that as the employer has a fixed cost in dollar contributions in any event, no profit accrues in stretching out for yield and capital gain. Once the dollars are contributed, they vest in the employee at least contingently, and therefore, a somewhat conservative portfolio is normally adopted because of the fiduciary aspect of the investment.

To an extent, the same situation applies to union-negotiated flat benefit plans. While it is true the company cost will be reduced by excess yield and capital gain, such reduction will quite probably pertain only until the next negotiation date when increased benefits will become an issue.

With a unit benefit plan based on current or average salary, however, there is a very good incentive to invest aggressively. If it is true, as stated at the beginning of this article, that these plans are simply not adequate, then reserves should be created through the means of increased yields plus capital gains to enable the benefits to be amended upwards at no greater outlay from the company.

When it is realized that an excess in yield of only ½% over the actuarial assumption will reduce company cost in a unit benefit plan by some 10%, and sometimes much more, it may be

readily appreciated how important yield and capital gain may be to the fund.

If, of course, the plan is on the final earnings basis, it is almost essential that a minimum of 25% to 30% equity investment be employed. Projections for the future must be predicated on a well-educated guess based on past history plus what economists see ahead for Canada's economy. Most of such prognostications come up with an average of 8% per annum for the foreseeable future for the combined capital gain and yield of a balanced growth equity portfolio.

Conclusions

The relatively brief history of industrial pension planning indicates that the situation is by no means static. Implementation of and changes in government benefits and tax regulations have brought about many changes from year to year. The progressive depreciation in the purchasing power of the dollar may require a continuing program of benefit improvement. It is of the greatest importance that all employees be made fully aware of the tax advantages of their personal contributions.

Perhaps considerable effort will be required through discussions, meetings and employer leadership to sell employees on the desirability and necessity for savings on their own account to the best of their ability. This, if followed through, will be a small price to pay for insurance against the most undesirable possibility of governmental regulation and control.

In the field of pensions, the chartered accountant has a real opportunity not only to approve and attest as to what has happened, but also to recommend ways and means for economies and improvements in the future.

A company with no plan at all or with a pay-as-you-go basis or a company that supplements pensions from revenue is obviously building up a hidden liability which one day may be of a most serious nature.

A company which funds its pension plan on other than the most economical basis may be contributing 15% or more in excess of that required.

It is not suggested that chartered accountants should supplant consulting actuaries or the officers of the pension division of a trust company. It is a fact, however, that they are in the primary position to discover and determine situations wherein employer and employees alike may be better served by an improvement in their pension planning and funding principles.

Tax Treatment of Patents in Canada

DONALD F. SIM

Although the Report of the Royal Commission on Patents, handed down in April 1960, makes certain recommendations for amendment of the Canadian patent laws, it is obvious that no fundamental change in the patent system in this country is contemplated and that patents will be with us for an indefinite period to come.

Before approaching certain specific matters arising out of patents which may be of special interest to accountants, it might be well to examine briefly the patent system as it exists in this country.

Patent Not Improper Monopoly

Patents (a term used in this article as referring exclusively to letters patent of invention) are often regarded as monopolies and thus are sometimes regarded with some of the suspicion and hostility which attach to that word. It is most important, therefore, that there be at the outset a clear understanding of the nature of letters patent of invention and the specialized monopoly which they provide.

The exclusive right which the law gives to the patentee to exclude others, for a limited term, from practising the invention which he has made is a natural and moral right. It differs from ownership of other forms of property only in that the owner is required to turn back the property to the public after a very limited term during which he has the right to its exclusive enjoyment. The distinction between a patent for an invention and a monopoly is, therefore, no more or less than the distinction between the right given to a person to enjoy his own property or the fruits of his own intellectual capacity, on the one hand, and the restriction of the public in a freedom or liberty which it had before the grant of the monopoly, on the other.

A monopoly is contrary to the view of the law and public morality, therefore, only if it takes away something which was enjoyed by the public before the grant was made. The patent system, since it give the inventor a monopoly only in that which he himself has contributed by way of development and research and then only for a strictly limited term, can surely not be considered to be an improper monopoly.

Right of Patentee

A Canadian patent gives the patentee the exclusive right to manufacture, use and sell to others to be used,

the subject matter of the patent in Canada for a period of 17 years from the grant of the patent. A patent cannot be renewed or extended beyond its 17-year term, and a careful examination of the subject matter of the patent is made by trained examiners in the Patent Office in Ottawa before the patent is granted to insure that the subject matter of the patent is new and useful and that the patentee is not extending his monopoly to things which he did not invent.

It is the object of this article to study certain aspects of the patent system which may be of particular interest to those in the accounting field.

Of primary concern to all is the problem of taxation, which gives rise to the most frequent accounting problems in the patent field. We are all well aware that questions of income tax must be carefully studied in light of their own particular facts and circumstances and that it is dangerous to attempt to theorize with too much particularity, but certain general principles can be drawn which are of use in assessing particular problems of patents and income tax.

A Capital Transaction

The basic principle of the Canadian income tax statutes is that income is the standard of taxation and that capital gains or accretions are not subject to tax. A patent is a capital asset; thus, unless the patentee can be considered to be in the business of making a practice of making inventions or acquiring patents and re-selling them, the outright sale of patents by inventors and others constitutes a transaction of a capital nature and is not subject to tax. It is also clear, however, that dealings with patents in the nature of licences involving royalty payments based on use are income transactions which create a liability to tax.

Having accepted the general proposition that the sale of a patent is a capital transaction, while the licensing of a patent for a royalty is an income transaction, it but remains to draw the line between the sale and the licensing of a patent. In drawing this line the prime consideration is whether or not the sum paid to the patentee is in any way based upon *use* of the invention by the purchaser and whether or not the vendor retains a reversionary interest in the patent as a result of the transaction.

Basic Question

The question for determination in each case is: "Was the price paid to to the patentee based upon use of the patent, or was it an outright sum payable either as a lump sum or instalments regardless of the extent of use by the purchaser?" Obviously, a royalty based on sales will be considered as income in the hands of the patentee as being in the nature of a profit received in respect of the capital of the patent. It must follow that if the purchaser is obligated to pay a certain sum regardless of his use or otherwise, then the mere fact that that sum is not paid in a single instalment, but may be extended over a considerable period of time should not affect the capital nature of the transaction. This is clearly expressed in *No.* 353 (1936) 9 S.A.T.C. 82, per Nathan K.C. as follows:

"The mere fact that the payment is stipulated by annual instalments is not conclusive in itself. There are many cases in which property is purchased and the purchase price is payable by annual instalments. The na-

ture of the transaction is not varied on that account. The thing purchased is a capital asset. A recurring capital payment is still a capital payment. It is clear that, where an exclusive licence has been granted, in that case the licence is a capital asset. The grantors of the licence have parted during the whole of the period of their patent rights with their right to use the patent. This is clearly a case of parting with the capital asset, and what the appellant company did was to pay a purchase price for that capital asset although a portion of it was expressed to be by annual instalments."

The other side of the coin is equally well expressed in *Pope Appliance Corp. Ltd.* v. *Minister of Customs & Excise* (1927) Ex. C.R. 17 where Maclean J. said:

"The appellant also contends that the licensing in Canada of its patents is virtually a sale of these patents with payments deferred, and that the payment of royalties therefor periodically, is but a receipt of payments on account of such sale, and are capital sums and not income . . . The contention . . . cannot . . . be maintained. The royalty received by the appellant is for the use of its inventions. The payment or royalty is in respect of the user of the inventions, measured by the quantity of production of paper, which may vary according to the machine to which the invention is attached, the speed, etc. . . . The bargain is that the licensee pay, not a capital sum, but a sum dependent on the volume of paper produced."

The whole position is clearly expressed in an Indian case *Anant Ram Khem Chand* v. *Commissioner of Income Tax, Punjab* (1937), 5 I.T.R. 511 where Takchand J. said:

"If the transaction was an out-and-out sale of the patent for a definite fixed price, even though it was not payable in lump sum but in instalments, there can be no doubt that any such instalment received during the accounting period cannot be treated as taxable 'income' but is a 'capital' receipt. If, on the other hand, it was merely a 'working licence' granted for an annual payment, it is clearly 'income' . . . We must look to the substance of the transaction."

Similarly, although a transaction in respect of a patent may be expressed to be an assignment in return for the payment of a certain sum not related to use of the patent, if the patentee retains any right to re-acquire the patent under certain circumstances, there is every possibility that the transaction will be regarded as an income transaction and not as a capital transaction.

A Corollary to the Principle

An interesting corollary to the principle that anything less than an outright assignment by the patentee of all his rights will be considered as an income transaction is illustrated by *No. 442*, 57 D.T.C. 435. In that case it was held that a territorial assignment not based upon use, but limited to the right to practise the monopoly in a defined geographical area, was a capital transaction. In that case Mr. Fisher said:

". . . where a patentee grants an exclusive licence, thereby precluding himself from exploiting his patents *in the area covered by the licence*, and receives therefor a capital sum, which is estimated in advance and without any relation at all to any user of the patent, that lump sum payment is a capital receipt which is not subject to income tax."

Subject to this territorial aspect, however, anything approaching a substantial reversionary interest in the patent may be anticipated to be fatal to the argument that the consideration received should be free of tax as a capital receipt.

From the standpoint of the purchaser the problem is considerably simpler. A person who purchases a capital asset, such as a patent is permitted by the provisions of section 11(1)(a) of the Act to write off the cost of the patent to him over the life of the patent remaining at the time that the asset was acquired (Regulation 1100(1)(c)). If the licence is acquired under the patent in return for a royalty based on use, then the royalties paid are clearly deductible under the provisions of section 11.

The provisions of section 11(1)(a) of the Act also apply to the patentee himself so far as concerns his legal and other fees required to obtain a patent. In this case the legal and other expenses necessarily incurred in acquiring a patent may be written off by the inventor over the 17 years for which the patent extends. It would appear that legal and other expenses incurred in applying for a patent which is ultimately refused are not deductible from the income of the inventor or applicant.

Litigation Expenses

The expenses of patent litigation also require careful consideration. Section 12(1)(a) and (b) of the Income Tax Act read as follows:

> In computing income, no deduction shall be made in respect of . . . (a) an outlay or expense except to the extent that it was made or incurred by the taxpayer for the purpose of gaining or producing income from property or a business of the taxpayer.

> In computing income, no deduction shall be made in respect of . . . (b) an outlay, loss or replacement of capital, a payment on account of capital or an allowance in respect of depreciation, obsolescence or depletion except as expressly permitted by this Part.

It is obvious that problems of nicety can arise in the case of patent litigation where the whole basis of the plaintiff's action is the setting up of a capital asset and an attempt to prevent the defendant from encroaching upon that asset.

While there have been few cases in which the deductibility of legal expenses in connection with patent litigation has come for consideration, a general principle may be derived from the judgment of the Supreme Court of Canada in *Kellogg Co. of Canada Ltd. v. M.N.R.* (1943), S.C.R. 58. In this case the Kellogg Company had been the defendant in substantial litigation in which it was charged with infringement in connection with the trade mark "Shredded Wheat". The Exchequer Court held that the expenses were properly deductible as they brought into existence no asset which could appear as such on any balance sheet nor did they procure an enduring advantage for the taxpayer's trade. The expenditures constituted an involuntary expense, not a disbursement incurred once and for all or for the benefit of a trade. In dismissing the appeal by the Minister, Duff, C.J. observed:

"As regards this payment, the question in issue was whether or not the registered trade marks of the plaintiffs in the action were valid trade marks, or, in other words, whether or not the present respondent, the Kellogg Company, and all other members of the public were excluded from the use of the words in respect of

which the complaint was made. The right upon which the respondents relied was not a right of property, or an exclusive right of any description, but the right in common with all other members of the public to describe their goods in the manner in which they were describing them."

The Kellogg case was followed in *Reclaimo Co. (Canada) Ltd.*, 59 D.T.C. 505 where the defendant was permitted to deduct legal expenses incurred in the successful defence of a trade mark action brought to restrain it from using the trade mark "Reclaimo".

This principle appears to settle the position of a defendant in an infringement action relating to patents as being able to deduct an expense in defending himself from a charge of infringement because he is not relying upon a right of property, but rather the right in common with every member of the public to be allowed the liberty of continuing certain acts. It would also appear that whether the defendant is successful in litigation or not should not affect the principle that the expenses incurred were in an attempt to maintain his business position.

Although there does not appear to be a case in point, it would appear that the damages which an unsuccessful defendant is required to pay to the plaintiff are also deductible as in the nature of royalties or rents payable to the patentee.

Position of Plaintiff

The position of a plaintiff in a patent action has now received the benefit of a recent decision of the Tax Appeal Board. In *Dole Refrigerating Products Ltd.* 60 D.T.C. 416, released by the Board on July 6, 1960, the Dole Company was the plaintiff in an Exchequer Court action claiming an injunction and damages against a defendant who, it alleged, infringed a patent owned by it. The Board held that the legal expenses incurred in this litigation *in which judgment had not yet been delivered* were deductible as costs incurred in preserving and maintaining the trade of the appellant. The Board, in arriving at its decision, took the position that the expenses of the litigation were costs incurred for the purpose of preserving the taxpayer's income position. The decision is in line with that of the Exchequer Court in *Hudson's Bay Co.* v. *M.N.R.*, 1947 Ex. C.R. 130 and the judgment of the Board was expressed to be based upon the *Kellogg* and *Reclaimo* cases already discussed.

It is significant to note that the fact that the expenses were allowed before the decision of the court was given must lead to the conclusion that legal expenses incurred by the plaintiff are deductible whether the plaintiff is successful or not.

While the point has apparently not been decided in any reported case, it would appear that sums received by the plaintiff by way of damages from an infringing defendant would be considered to be in the nature of a royalty or rent received by the plaintiff on account of the unauthorized use of the patent by the defendant.

Valuation of Patents

Any member of the legal profession must approach this particular subject with considerable diffidence in view of the italicized statement contained on page 5 of Mr. A. V. Adamson's useful book "Valuation of Company Shares and Businesses". Mr. Adamson states quite categorically that "there is no place for advocacy in the

making of a valuation". It is probably thus presumptuous for a member of the legal profession to advise those of the accounting profession on such a topic, but perhaps a few general statements can be made on the question of valuation, most of which are derived from discussions already mentioned on the capital and income nature of patents.

The writer must respectfully take issue with the treatment given to patents by Mr. Adamson in his book. Mr. Adamson states (page 127) that:

"Patents . . . are more in the nature of intangible assets, and in many instances their value is indistinguishable from that of goodwill. Even if they had been paid for, quite apart from goodwill, they could not be included in an appraisal of tangible assets unless it could be demonstrated that they command a separate value and could be sold without affecting the main goodwill."

It is respectfully suggested that any patent may and should be assigned a valuation quite independently of the goodwill of the business in connection with which it is used. Since, as we have seen, a patent is clearly a capital asset and not intangible, and since the owner of the patent is permitted to write off the cost of acquisition of the patent over the life of the patent remaining at the time of his acquisition, at the very least, every patent should be valued at the depreciated cost to the patentee. This would mean, in the case of the inventor, the legal and other costs necessarily connected in obtaining the patent and, in the case of an assignee, the sums paid to acquire the patent, to the extent that such capital costs had not been written off at the time that valuation is to be made.

There may be cases where it is sought to evaluate a patent which has been licensed to another in return for a royalty. In such a case it is suggested that the proper valuation can be made having regard to the income received by the licensor and the term remaining during which the royalties are likely to be received. In such a case, given the past history of the royalty payment on the remaining life of the patent, evaluation would be a relatively simple task for an accountant.

Purpose of an Audit

In the distant past, audits no doubt had their origin in the natural distrust felt by one man for another in matters where the handling of money or other valuables was at stake. The function of the auditor then was to obtain an account of a man's stewardship and to assure himself that no misappropriation of funds had taken place. With the passage of time, as businesses developed and grew into complex organizations, this original concept of the auditor's function became impracticable and outdated. Nevertheless, it is only in relatively recent years that it has begun to be accepted that balance sheets and profit and loss accounts are representations made by management as to a state of affairs and results of transactions; and that the function of the auditor is to express an opinion on those representations.

—D. D. R. Smith, "Auditing: The Purpose and its Attainment," *Accountancy*, September, 1960

An Introduction to Punched Card Accounting

EDWARD R. MAYNERICK, C.A.

In recent years more and more companies have been entering the field of punched card accounting for the first time, or have been advancing toward greater mechanical integration of procedures. The increasing importance of punched card accounting makes it imperative that management should possess a sound knowledge of the subject, since any decision in this area will be of major importance to the company. If the decision to mechanize an application is made by an informed management after careful study, the fruits should be reduced costs and better and faster reports. If inadequate knowledge exists, management may either enter a costly mechanization program prematurely, or else penalize the company by not recognizing potentially profitable machine applications.

As a corollary to the above, the public accountant should also possess an understanding of punched card accounting, since he may be called upon to advise his clients in this regard. In any case, such a knowledge will help him in the audit of companies utilizing punched card systems.

Recently a great deal of excellent literature has been published on punched card accounting. Unfortunately, the authors generally assume that the reader has a working knowledge of the subject, but this is not always the case. The purpose of this article is to attempt to outline the information necessary to develop an appreciation of punched card accounting. This will be done by comparing the punched card system with the manual system, describing the functions of commonly used punched card machines and the basic machine applications. Following this, some general considerations will be presented regarding punched card accounting.

Punched Card v. Manual System

The fundamental difference between a punched card and a manual system is that under a punched card system the information pertaining to a transaction is key-punched into a group of cards. These cards are then used to prepare a number of different reports or documents mechanically. Under a manual system, each report or document usually requires individual manual operations. For instance, in the case of a sale, the manual key-punching of cards would be roughly equivalent to the typing of an invoice. However, with machines all other operations would be

mechanical. The cards are fed into a printing machine in which the sensing of holes in the cards closes electrical circuits to activate the printing mechanism, resulting in the printing of the invoice. The cards are then fed into a sorting machine which sorts the cards at high speeds into order, first by market area number and then by salesman, customer and product numbers. After each sort, the cards are entered into the printer to print the relative report. With a manual system, the arranging of data for the various reports is generally time consuming, and manual retypings are required for each report. Indeed, the facility of machines in arranging cards into a desired order with relative ease sometimes makes it possible to prepare reports not conveniently prepared under a manual system.

From the above, it can be seen that a punched card system will reduce the number of manual operations. However, for the machines to pay for themselves, they must be kept reasonably busy. To be kept busy, there must be a fairly large number of like transactions to be processed so that the high speeds of the machines can be utilized effectively. If the volume of transactions is small, or if the number of exceptions to the ordinary routine is large, the flexibility of the manual system in which individuals can change from one type of operation to another with a minimum of lost time makes a manual system more suitable. Although machines do not have this flexibility, they are able to handle expanding volumes and peak periods with much less difficulty because they can process a great many additional transactions in an extra hour or two.

Another facet of the volume problem is that the ability of the machine to cope with larger volumes sometimes makes it possible to obtain greater accounting control in such areas as inventory and accounts receivable. For instance, it may be possible to maintain a perpetual inventory under a punched card system on an up-to-date basis, whereas the volume of transactions may make this impossible under a manual system where handwritten postings to stock ledgers would be necessary. If volumes are small, this may work the other way, because transactions must usually be batched before processing under a punched card system, whereas under a manual system transactions can be posted immediately as they occur.

A distinct advantage of a punched card system lies in the ability of machines to perform additions and extensions more rapidly and more accurately than is possible using manual methods.

Equipment Requirements

Although there is a wide array of machines available on the market today, those noted below are essential to most systems. A very small standard system might require only the first three, and if designed to handle standard sized punched cards, the rental would start at about $300 a month.

1. *Key Punch* – used to punch information into cards usually from source documents. Has a typewriter type keyboard.
2. *Sorter* – sorts cards into a desired sequence.
3. *Printer* – otherwise known as an accounting machine or a tab.

   The punched cards are read by this machine and reports, invoices, cheques, etc. are printed. This

machine has counters with which to add and subtract amounts punched in the individual cards. If totals only are desired, printing of detailed items may be suppressed.

4. *Summary Punch* — this machine is connected to the printer by a cable. A summary card may be punched for totals accumulated in the printer. For example, a single accounts receivable summary card may be punched simultaneously as an invoice is being printed from detail cards.
5. *Verifier* — used to verify correctness of key-punched cards.
6. *Collator* — used to merge two decks of cards or to select certain cards out of a file of cards.
7. *Reproducer and Gang Punches* — used to read information from one card and punch it into another card.
8. *Calculator* — used to perform multiplications, divisions, additions, and subtractions. Results are punched into a card.

Applications

The following is a description of the basic punched card applications. There are many possible variations, and the exact system suited to a company will depend upon its individual circumstances.

Billing

Billing is usually the first application to be mechanized. This is because the volume of transactions is large and also because related sales statistics are highly suited to machine techniques. The two general systems followed in invoicing are known as pre-billing and post-billing.

Pre-Billing

If pre-billing is used, accurate perpetual inventory records are kept in punched card form in the accounting department. Both the invoice and shipping documents are prepared simultaneously by reference to the inventory records.

One common method of pre-billing is as follows. Pre-punched cards in a tub file form the perpetual inventory record. A card will exist for each unit of product, or some standard multiple thereof, in inventory. When items are received into stock, the necessary cards are punched and added to the tub file. When a sales order is received, a card is pulled from the tub file for each detail item. If a card is not available, an out-of-stock condition is indicated. In addition to the detail cards, a name and address and a terms card is pulled. These cards are then entered into the printer to print the invoice and shipping document. The shipping document goes to the stores department as authority to ship the goods.

Variations of the above procedure may be followed when the size of the tub file becomes too cumbersome.

Post-Billing

Under a post-billing system the sales order is routed through the shipping department where shipping documents are made out with reference to the stores perpetual inventory records, or to the physical stock on hand. The sales order is adjusted for out-of-stock conditions, and is then forwarded to the machine accounting department for preparation of the invoice. In the machine room a pre-punched name and address card and a terms card is pulled from a tub file. For each detail item either a card is key-punched or else a pre-punched card is pulled from a tub file. The above cards are fed into a calculating machine to extend units

× price and to calculate discounts. The cards are then placed in the printer to print the invoice.

It can be seen that the greatest streamlining is attained where a prebilling system is used.

Sales Statistics

As mentioned earlier, the sorting of cards into a desired sequence is done quite rapidly by the sorter. If the customer, salesman, territory and product numbers are punched in the detail cards used in invoicing, the cards may be sorted into the respective sequences and reports printed.

Accounts Receivable

During the printing of an invoice, an accounts receivable summary card is automatically punched by the summary punch machine attached by a cable to the printer. This card, containing the customer number, date, invoice number and amount, is placed in the accounts receivable file. When a payment is received, a card is keypunched with the information and is likewise filed. Control totals are developed during the process for posting to the accounts receivable control account.

In preparing monthly statements, a name and address card is mechanically merged with the accounts receivable file, and the combined file is then entered into the printing machine to print the statements. As each statement is printed, a new accounts receivable balance forward card is summary punched and then is placed in the current accounts receivable file. All the detail cards for the preceding month and the old balance forward cards are placed in a dead file.

Since ageing information will also be contained on the accounts receivable balance forward card, the aged trial balance of receivables is prepared mechanically from these cards.

By varying the above procedure slightly, an open item type rather than a balance forward type receivable statement can be prepared. Unpaid invoices from prior as well as the current month would then be printed on the receivable statements.

Accounts Payable

Punched card procedures generally start after the invoice has been approved for payment. At this time an accounts payable card is made out for the total of the invoice and a separate distribution card for each account to which the invoice is to be distributed. These two sets of cards are zero balanced to prove accuracy.

The accounts payable cards are sorted into sequence by vendor number each day and a machine listing is made which becomes part of the invoice register. The cards are then entered into an unpaid file which in effect is the accounts payable subsidiary ledger. When a supplier is to be paid, all cards pertaining to him are pulled along with his name and address card. These cards are fed into the printer to print a remittance statement and cheque. At the same time a cash payments card is automatically summary punched. This cash payments card is listed to form the cash payments register.

To obtain the trial balance of payables at the month end, the accounts payable cards in the unpaid file are simply listed on the printer and the total agreed with the general ledger balance.

To obtain the accounting distribution of charges, the cards on which charges were distributed are sorted by account number at the month end and a detailed distribution is printed. If subsequent procedures are to

be mechanical, a total card for each account is summary punched. Otherwise posting to the general or subsidiary ledgers is made manually from the above list.

Payroll

The routine nature of payroll work generally makes it a good machine application. For the sake of simplicity, this illustration assumes that the employee works at several operations but receives only one pay rate, and also that standard costing for labour is not involved. These latter situations would also be amenable to machine processing.

Three master files are kept:

(1) Employee name, rate, and tax exemption master cards.

(2) Standard deductions cards.

(3) Year to date cards.

Each week a card is prepared from the employee clock cards showing employee number and total hours worked. In the factory, time sheets are prepared showing the operations performed by the employee and related hours. From these sheets, a card is prepared for each operation that the employee performed showing employee number, number of hours and operation number. The cards from these two sources are forwarded to the payroll department where the time is zero balanced on the printing machine and any differences investigated and adjusted. The employee name, rate and tax exemption master card is then merged and the combined file is entered into the calculating machine which takes the employee's pay rate from the master card and extends rate × the hours worked, and punches the results in both the distribution cards and the total hours worked cards. The distribution cards are selected for the preparation of labour distribution reports.

A second pass through the calculating machine of the employee name, rate and tax exemption card, and the total hours worked card will be necessary to calculate the tax payable. This amount is punched in the card showing the total hours worked. The standard deduction cards are then merged, and the whole file is run through the printer to print the payroll cheques and deduction stubs.

The next step will be to merge the year-to-date cards with the cards from above. From this combined file the payroll register showing year-to-date figures is printed, and an updated year-to-date card is summary punched.

The punched card approach is especially valuable in accumulating year-to-date figures, thus the preparation of T4 slips at the year end presents no problem. The use of the bulk method of deducting unemployment insurance is also facilitated.

Office Salary

The fact that salaries are more or less static makes it possible to prepare the cheques and the salary register directly from a master file containing employee number, name, deductions, gross and net pay. The same cards are used again for each pay period. Adjustments, of course, are made for salary increases, new staff, etc. The master file as adjusted is used to prepare the pay cheques, the payroll register and an updated year-to-date card for each employee.

Other Considerations

Source Documents

The importance of having correct source documents cannot be overemphasized. Although the control

panels of the machines are wired to detect some types of errors, the correction of the errors at this time is costly because the machine is tied up for a varying length of time while corrections are made. On the other hand, some types of errors will be perpetuated longer than if competent clerks do the work under a manual system and are in a position to notice and investigate abnormal occurrences. However, if the source documents are correct, the likelihood of errors occurring later under a mechanical system is slight as compared to a manual system.

Internal Control

Good internal control is as important with a machine system as with a manual system. One of the most important procedures is the developing of control totals on source documents going into the machine room, and the subsequent balancing of machine totals to these. This procedure is especially valuable because errors can be discovered and corrected immediately. Sloppy machine installations do exist, however, and in such cases it is extremely difficult to locate errors made in prior periods.

Some people have the impression that a lost card is catastrophic. In a well-run installation a card is rarely lost. In any case, it is almost always possible to reconstruct an account in order to establish the information on the lost card. Control procedures should reveal the loss of the card.

During the course of mechanizing, two major problems must be resolved. First, product numbers and customer numbers, generally numerical, must be developed with utmost care so that the mechanical arranging of cards into various sequences for the preparation of reports is facilitated. Secondly, the information on source documents may have to be revised to include all the data needed to permit the greater analysis of data usually desired from a punched card system.

Subsequently, to encourage maximum efficiency in the machine accounting department, carefully prepared schedules of work flows should be set up. In addition, the machine room supervisor should be made responsible to a senior executive and should submit a report showing actual and scheduled dates for the receipt of source documents and the completion of final reports. The executive should initially ascertain that, so far as possible, the more important reports are scheduled to be completed first. He should then see that deadline dates on source documents and reports are being met. Poor scheduling may lead to extra machines being rented needlessly.

Aside from technical problems, a careful education of the staff is needed to ensure their cooperation in making the new system work. Employees for the machine accounting room are generally selected from existing personnel because operation of the equipment is not especially difficult. If at all possible, the staff should be told, for the sake of staff morale, that no one will be dismissed. Reductions in staff could then result from normal turnover. The elimination of routine jobs should lead to the up-grading of the staff in the long run.

Conclusion

In recent years there has been a growing trend to punched card accounting systems. There are many reasons for this. The ever-rising cost of clerical labour has made such sys-

tems more attractive to management. The increasing paper work brought about by management's desire to obtain more information faster has created data processing problems that in many cases have been resolved by mechanization. In addition to this, punched card equipment has been constantly improving in variety, quality and speed — new low-cost machines are economical even to small companies. These underlying factors indicate that the trend toward mechanization will continue.

Machine accounting has come a long way since the brilliant Dr. Herman Hollerith developed the first punched card system for the United States census in 1890. Amplifications of the basic punched card system by punched tags and punched paper tape have greatly extended the possibility of processing data mechanically. The recently developed computer, by processing data at incredible speeds, is also having a profound effect on business. We may expect that the exciting new machines now on the horizon will ensure still greater progress in the future.

How Appropriate Are "Accounting Principles"?

Changes in economic and social conditions have had some effect on accounting principles and their application, but in this area the accounting profession has too often looked backward rather than forward. When a relative comparison is made for the last 25 years between improvements in accounting principles and practices and the major developments in other fields, the former suffer by comparison with the developments in scientific research, in production, marketing and distribution methods, and in management techniques during this era of atomic power, electronic computers, jet airplanes, colour television and wonder drugs. Accounting principles, as reflected in actual practice, in my opinion, have not kept pace during this period with the needs of our democratic, free-enterprise system.

The suggestion has sometimes been made that the term "accounting principles" is misleading and creates the wrong impression, because it indicates a precision that is not actually present. This term could be changed, but there does not seem to be a better alternative, and any substitute that would convey the idea that there is less of an authoritative basis for accounting might not adequately serve the desired purpose. While admittedly some confusion exists with respect to terminology, the real challenge to our profession is not a revision of words or the clarification of definitions but the development of underlying postulates and concepts to provide a proper basis for the determination of appropriate accounting principles and practices.

—G. R. Catlett, "Factors that Influence Accounting Principles", *The Journal of Accountancy*, October 1960

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Accounting for Price Level Changes

I. Some Arguments for and Against Adjustments

R. M. Skinner, C.A.

"Income, determined by accepted accounting conventions, is overstated by one-third to one-half. Taxes on business income, which are determined largely in relation to accounting income, may take 60%, 70%, or 80% of real income rather than the percentage indicated by the nominal tax rates. As a result, dividends and taxes together often exceed the real income of a company, and many companies today are living on capital without realizing it." These charges have been made repeatedly in the past 15 years. They have been made by many economists, businessmen and accountants, and in some cases are backed up by impressive research studies. They have not, however, gone unchallenged. Many accountants deny their validity, and still more oppose any change in established accounting conventions, regardless of the merits of the charges.

Three Criticisms

Because of the inflationary conditions of the past 15 to 20 years, three general criticisms have been levelled against established accounting conventions:

1. Existing inventory accounting conventions (with the exception of the last-in, first-out convention) overstate income, because the charge against income for cost of goods sold is not computed at current replacement costs, but rather reflects costs incurred by the business at some date prior to the date of sale, when price levels were lower. Because the amount charged against income is not equal to the outlays required to replace the goods sold, the real capital of the business will be impaired unless some part of the reported income is retained to cover such additional replacement cost.
2. Existing fixed asset accounting conventions overstate income because the depreciation charge against income is computed by reference to the original dollar cost of such fixed assets rather than their replacement cost. Once again, where replacement costs exceed original costs, this means that the sums charged against income will not be equal to the outlay required to replace the assets at the end of their useful lives, and therefore real capital is impaired

unless some so-called earnings are retained.

3. Existing accounting conventions give no recognition to changes in the purchasing power of money assets held by the business, or of liabilities owed by it. Under inflationary conditions the same dollar amount of assets such as cash and accounts receivable is worth less in terms of purchasing power at the end of a year than it was at the beginning. On the other hand, the same amount of dollar liabilities owed by a business will take less real purchasing power to discharge at the end of a year than it would have at the beginning. Therefore a business during inflation suffers a purchasing power loss on cash balances held, or assets equivalent to cash, but makes a purchasing power gain on liabilities, so that there may be either a net loss or gain depending on whether the net monetary position is positive or negative.

The last of these criticisms is not normally regarded as being as important as the first two. In fact, a number of writers on the subject would exclude losses or gains in purchasing power of monetary assets from the income statement on the grounds that it is possible for a business so to arrange its affairs that its monetary liabilities exactly equal its monetary assets, and therefore gains or losses in purchasing power of the monetary position are not necessarily associated with the carrying on of business.

On the other hand, those who favour modification of existing accounting conventions are almost unanimous that adjustments to both depreciation and inventory accounting are necessary to reflect changes in the value of money. They do not, however, agree on the method by which this should be accomplished. Some propose basing the charge for depreciation, or for goods sold, on the replacement cost of the assets in question. Others would base the charge against income upon the original cost of these assets adjusted only for changes in the general purchasing power of the money between the date the assets were purchased and the date of the income statement.

Reasons Against Adjustment

Those who oppose the proposals put forward for adjustment of accounting conventions do so on a variety of grounds:

1. The main purpose for which accounting statements are produced is, and always has been, to report on the stewardship of management in handling the capital funds entrusted to its care. The best way to keep such reports unbiased is to record in the accounts only costs actually incurred in the transactions consummated by management, and the disposition of such costs. This reliance on actual cost for general accounting purposes is fortified by company law, wherein legal capital is defined in terms of the amount of money actually contributed to the company, and not in terms of the real assets bought with such money. Therefore, in order to keep clear the dis-

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tinction between capital which legally must be maintained and income which is legally distributable, it is necessary to keep the accounts so as to reflect the money costs actually incurred by the company. While it may be true that it may not be wise for a company to pay out all of its income so defined, this is a fact to be taken into consideration in setting financial policy, and not one calling for a revision in established methods of income determination.

2. Users of financial statements generally understand present accounting conventions and their limitations and are able to use them with confidence. Changes in accepted accounting methods would introduce confusion and therefore make accounting statements less generally useful. In addition, many legal or quasi-legal rights and obligations now defined in accounting terms might be affected by changes in accounting practice which would be confusing, at the least, and possibly inequitable.

3. All the methods proposed for adjustment of accounts involve a lessening of objectivity and an increase in uncertainty. For example, many companies adjusted their accounts in the 1920's by appraising their fixed assets at values substantially higher than original cost, and recording such values on the books. These appraisals were often supported by the opinions of the best of independent valuers. In many cases, however, subsequent experience proved that these values could not be maintained and securities issued on the strength of them had to go through the wringer of reorganizations in the 1930's. Today, it is hoped to avoid some of these problems arising out of overoptimistic appraisals through the use of index numbers for adjusting fixed asset accounts. However, problems still arise in the choice and selection of the index or indices used.

4. Some of the methods proposed for adjusting accounts improve the significance of the income statement only at the expense of a further reduction in the value and significance of the balance sheet. This criticism is valid as against the *Lifo* method of inventory valuation and various accelerated depreciation methods, unless supplementary information is given, which, in practice, is rarely done.

5. Specific methods for adjusting accounts which depend on the substitution of replacement values for historical costs are criticized not only on the grounds that such replacement costs may be difficult to determine, but also on the grounds that such methods still do not result in a figure for income which will ensure the retention of funds within the business for replacement of fixed assets. This is because, under conditions of a steadily rising price level, a provision for depreciation based on replacement costs today will be inadequate when replacement is actually required tomorrow, owing to the intervening rise in prices.

Other Arguments

Apart from arguments about the validity and usefulness of the various techniques proposed for adjusting accounts, both sides to the controversy raise arguments of social policy against and for the proposed changes. For example, it is argued that any changes in accounting techniques would re-

inforce any inflationary tendency, since business generally would tend to raise its prices if its accounts showed that profits were considerably lower than the amounts at which they are now stated. Proponents of change contradict this assertion. Even if it is granted that there might be some pressure for higher prices from some businesses, it does not follow that this would necessarily be inflationary in its total effect. A more realistic picture of the real level of business profits might reduce the pressure of labour for higher wages, of shareholders for higher dividends, and also might make expansion appear less attractive to business itself, thus reducing the demand for credit. In other words, while such development might involve a shift in the distribution of the national income, this would not be inflationary unless business tended to spend its increased share of the national income faster than its former holders.

Again it is argued that adjusted accounting methods for reporting income would be used to bring pressure for income tax relief for business, and this would be discriminatory in the absence of a far-reaching overhaul of the income tax system. For example, a bondholder pays taxes on interest received, even though the real value of his bond may be declining nearly as much each year as the nominal rate of interest. If the basis of taxation is to be changed, is he not as entitled to relief as is business?

To this question proponents of accounting changes reply that accounting methods are one thing, and tax policy is another. Methods for determination of taxable income are not necessarily the same as methods for determining accounting income, and improvements in the latter should not be prevented by considerations of the possible effect on the former.

Other arguments of this nature could be cited. Enough has been said, however, to indicate that this question of adjusting the accounts to reflect changes in the value of money is extremely contentious, both in its underlying theory and in practical application. Part of the difficulty is caused by the fact that the two sides to the controversy apply different meanings to the same words, and therefore argue at cross-purposes. Some clarification, therefore, of the concepts upon which each side builds its arguments will be useful.

Capital and Income Concepts

In its essentials the controversy revolves around the concept of "capital" and its complement, "income", and the questions:

1. What are the meanings of the words "capital" and "income"?
2. Does the accounting art faithfully portray these meanings in financial statements, in particular when it displays figures labelled as "net income" or "net income for the year"?

The sternest criticisms of accounting methods of income determination come from the economists, or from others who believe that the economists' concept of income is the "true" or the "ideal" concept on which accounting conventions should be based. Most economists would agree, broadly, with a definition of income as that amount that can be spent, distributed or otherwise disposed of by an enterprise in a period and still leave it as well off at the end of the period as it was at the beginning (after making the necessary allowances for any capital introduced or withdrawn during the period).

There are two points to note about this definition. First, the term "as well off" means as well off in terms of purchasing power or command over real, physical wealth. Secondly, since the determination of income is based upon measurement of well being at the beginning and end of a period, it is essentially a process of valuation. And while some assets can be valued by reference to prices established in the market, other assets held by the normal business enterprise, such as fixed assets, work-in-process, etc., are not in marketable form. Therefore, they must be valued by reference to the future income anticipated from their use. As a result, the whole process of determination of economic income is very much a matter of highly subjective, personal opinion.

It will be admitted that the economist's definition of income in terms of the accretion to real wealth in a period is intellectually satisfying. If it were possible as a practical matter to obtain a valuation of the assets of a business regularly, expressed in units of measurement of a constant worth, there is no doubt that such information would be very useful. In the early days of accounting, in fact, statements were drawn up largely on a valuation basis. Even today, whenever a business is to be bought or sold, it is essential for the prudent investor or prudent seller to value the enterprise, even if only in approximate terms. As a successful financier has said, "I often buy a business on the basis of values shown by its balance sheet, but I never sell one on that basis".

Importance of Certainty

As business has become more complex, however, realistic valuation of its wealth becomes more difficult and uncertain, and is completely impractical for the purpose of determination of periodic income. Accountants therefore long ago turned to other bases of accounting. Certainty in accounting became possible through the introduction of the convention that no increase in the value of assets held for sale would be recognized until it was realized through sale. Therefore, prior to the date of sale assets are carried at cost, which is the original evidence of their value. In the case of assets having a limited life and not held for sale, a portion of the original cost has to be assigned, by some systematic method, to each period in their useful life, and this is accomplished by the charge for depreciation. The result is that revenues from assets sold are associated with the costs of assets sold and the other costs of carrying on the business, and the net difference appears as accounting income.

The certainty provided by generally accepted accounting methods is very important to the conduct of business. Dividend and other restrictions in trust deeds are defined in terms of sound accounting practice; profit sharing, royalty or rental payments, and other forms of distribution may also be determined by the amount of income measured by accounting methods; reported income per share greatly influences investment decisions. For all these purposes a consistent method of income determination, capable of being measured objectively and with certainty is of great importance. Indeed in recent months there has been considerable criticism of accounting principles on the grounds that they are too flexible and uncertain in their application, and too subject to variable individual opinion.

In these circumstances, when ac-

countants are confronted with a proposal for modification of existing accounting methods, the choice lies not between what is "right" and what is "wrong", but rather between two methods, each of which is useful for certain purposes and less useful for other purposes. The choice becomes, then, a matter of opinion, which makes it all the more difficult to obtain general agreement. Therefore, a duty lies upon all who are concerned with the measurement of income to think the problem through and arrive at a considered opinion.

A Considered Opinion

The following are one man's opinions:

1. Accounting statements are drawn up to be read, for the most part, by people who are not accountants. The terminology of accounting statements is drawn from everyday language, using such words as "asset", "liability", "net worth" and "income". In these circumstances, the meaning which accountants attach to these words should correspond as closely as possible with the meaning given them by the man in the street. If questioned, the man in the street would probably agree with the economist that income is the amount that he can dispose of in a period and still be as well off at the end of it as at the beginning. If, therefore, the accountant's definition of income differs materially from this concept, he can rightly be accused of confusing or misleading his readers.
2. It is a fact that changes in the purchasing power of money do occur. Therefore, the accounting postulate of stability in the unit of monetary value is unreal, and accounting conventions based on that postulate cannot reflect real values, or income, in the sense that the word is commonly understood. If fluctuations in the purchasing power of money were of small extent and truly fortuitous in nature, tending to vary about a dead centre of value, this unreality in accounting rules would be unimportant in the long run. However, the authorities, although none can be certain, generally agree that a long-run, downward trend in the value of money is more likely than an unbiased fluctuation or an upward trend. It therefore seems foolish for accountants to behave as though fluctuations are likely to cancel out.
3. It will be conceded that any of the methods that have been proposed for adjusting accounts to reflect changes in price levels rest upon approximations and therefore contain some risk of error. The degree of that error needs to be evaluated and compared with the error involved in not adjusting accounts for changes in the value of the monetary unit, and with the extra work involved in adjusting accounts.
4. There is no doubt, however, that if the rate of loss of purchasing power of money is fairly great, accounts prepared under conventional methods are almost completely unsatisfactory, as has been shown by experience in some other countries. Therefore, even though it may not appear desirable to make adjustments to the accounts upon existing circumstances, the accounting profession should still think this problem through, and decide what methods it would consider the best for

adjustment of accounts, if such became necessary.

5. If adjustments are to be made to reflect changes in the purchasing power of the dollar, it would be valuable to do this in such a way that the accounts continue to show the results that would have been shown under previously existing accounting conventions. Thereby it would still be possible to ascertain from the statements the amount of legal capital, and the income determined under previous accounting rules which is significant for various legal and contractual obligations. A second desirable feature of any method for adjustment of accounts would be certainty in its application. This would be one practical reason in favour of the use of a general price index for adjustment of accounts, if possible, rather than a number of specialized indices.
6. There would undoubtedly be serious transitional problems in the adoption of new accounting conventions to meet this problem. Ideally, in order to prevent confusion, a new convention should have general acceptance, be formally adopted by the recognized professional accounting societies and be introduced in financial statements, at least of those businesses that publish their accounts, over a relatively short period. However, in any proposal so controversial as this and so subject to individual opinion, there is no hope of gaining unanimity in any short period of time since there is no accounting legislature that will promulgate or interpret accounting conventions to the satisfaction of all. Therefore, changes to accounting statements to reflect price level fluctuations will necessarily be introduced piecemeal, if at all. In these circumstances there would seem to be considerable merit in the proposal that information required to adjust the accounts for changes in the value of money be given as supplementary information to the statements published in conventional form. In this way, the information that is required from conventional accounting statements could be obtained, while those who were interested in modified statements would have them also available.
7. In short, progress in solving this problem will depend on development somewhat along the following lines. Accounting societies should study the problem of accounting for changes in the value of the monetary unit and suggest the techniques for modifying conventional accounting statements or presenting supplementary data that seem most certain in application and most suited to meet the general problem. Businessmen should also study the problem, see how the techniques suggested work out when applied to their business, and publish the additional information in their reports, if it seems useful, along with explanations of the bases in which it is drawn up. With suitable explanation, there seems no reason why the auditors of a business should not give an opinion upon the general validity of such data. With trial and experimentation, experience will indicate the usefulness of these attempts. If they prove useful, the time may come when it is possible to merge conventional accounting statements and adjusted accounting statements in one, in order to

eliminate a possible source of confusion. Much work, however, lies ahead, before that goal is attainable.

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2. An Appraisal of Theoretical Techniques

W. B. Coutts, C.A.

This paper, as the title suggests, will discuss and evaluate some of the proposals which have been made for dealing with the problem of accounting for price level changes. It will not, however, deal with any specific proposals separately or in detail since they all have at least a few features in common and most of them deal with only one part of the problem. They do not, in other words, provide a complete, integrated system but cover only some limited aspect of the problem such as inventory valuation or depreciation, despite the logical impossibility of dealing with assets apart from liabilities or with income separately from net worth. Because of what seems to be the inherent illogic of such partial approaches, the techniques of adjusting for price level changes will be dealt with in very general terms, and specific problems will be discussed only in a few cases where it seems necessary.

The importance to the question under discussion of the concept of income and its relation to capital is generally recognized. The dispute is basically between the view held by accountants to the effect that the capital is a specified number of dollars and the preservation of capital means the preservation of that number of dollars and that held by economists to the effect that "capital" represents a specified quantity of goods or services, in short, a given amount of "economic power". The significance of this dispute is hidden as long as the value of money remains constant since the capital in monetary terms will continue to represent the same amount of economic power. If, however, the value of money itself has changed, the capital in terms of economic power will differ from the monetary capital. Obviously, then, the amount of income – the excess of net worth over capital – will also differ depending on which view of capital is applied. In times of declining money values, the income computed by the use of "fixed dollar" capital will differ from that produced by applying "economic" capital. This difference represents what might be called the "inflation profit" —the portion of the apparent increase in net worth which is due to the decline in the value of the dollar rather than to an increase in "economic power". It is the elimination of this "inflation profit" which is the object of the proposals under discussion.

When income is measured by a simple comparison of net worth, the elimination of the "inflation profit" seems easy; it involves nothing more than the conversion of the opening net worth into its equivalent in terms of year-end price levels. This, in turn, means in practice, the conversion of the opening values for assets and liabilities into their equivalent in terms of year-end price levels.

An Illustration

This can best be illustrated by a simple example. In this example a situation is assumed in which an original capital of $100 is all invested in

tangible assets. It is assumed further that at the end of the year the assets were all sold for $300 so that net worth will have increased by $200. Under the conventional accounting approach this $200 will all be income.

If, however, the value of money is known to have declined in the period, it is obvious that some part of the income will represent a change in the value of money rather than a relative increase in the exchange value of the assets themselves. By applying the "economic" concept of capital it can be determined that at the end of the year the purchasing power of the original capital of $100 would be equivalent to $200. In other words, it would take two hundred depreciated dollars at the end of the year to obtain the same general quantity of goods or services as was obtained for $100 at the beginning of the year. By comparing the closing net worth of $300 with the adjusted capital of $200, the portion of the profit *not* due to inflation can be determined to be $100.

From this, it would appear that in order to eliminate the inflation profit alone, it would only be necessary to re-value net worth at the end of the period in terms of the then current money values. Unfortunately, a little further consideration reveals that this is not the case if all of the assets are *not* sold during the period.

This can be seen if it is assumed, in the above example, that only one-half of the assets had been sold by the end of the year. In this case the conventional accounting net worth would be $200. The comparison of this figure with the opening net worth of $100 would produce a conventional profit of $100. The elimination of all of this profit by the use of an opening net worth expressed in current dollars would clearly be inappropriate, and yet the income obviously includes some inflation profit as well as some real profit. Further consideration of this example shows that the trouble arises from the failure, under these circumstances, to record *all* of the inflation profit and that to obtain a reasonable result, we must recognize the increase in the value of the unsold assets in order to offset the increase recorded in net worth.

The use of current market values for this revaluation would involve the inclusion in income of amounts representing fortuitous relative or specific price changes. Such profits or losses, being unrealized, would not normally be included in accounting income. It, therefore, seems necessary, unless we are prepared to change the generally accepted practice with regard to unrealized profits, to find a method for segregating the general or inflation price changes from the specific or relative ones.

The usual method suggested involves the use of "adjusted historical cost" rather than market value to revalue the assets. This figure, obtained by converting original cost to its equivalent in terms of current money values, reflects what the market value would be if no change had taken place in price levels except general ones due to changes in the value of money.

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If this procedure is applied to the example, the asset values become $250 – $100 of cash representing the sale price of half the assets and $100 representing the "adjusted historical cost" of the $50 of unsold assets.

This example has been simplified by assuming that income would be determined by comparing net worth at the begining and end of a period. In actual practice, of course, this would not happen. The method suggested, however, will be equally appropriate under a more complex situation in which income is computed directly. All that is required is to adjust the values of those costs charged to operations in the period to the appropriate year-end equivalent, to adjust in the same way the costs not charged to operations but carried forward in the balance sheet, and at the same time to convert the opening balance of equity into its year-end equivalent. The result will be a profit figure which will differ from the conventional accounting one only in the exclusion of the inflation profits.

It should be noted also that while the effect of the adjustment proposed in the case of what might be called "non-monetary" assets is to offset the increase in asset value against the increase in net worth so that no profit or loss is recognized, the reverse is the case with monetary assets, that is, those that represent a specific number of dollars rather than a stock of goods or services. If the company in the illustration, for example, had retained its original capital in cash, its net worth at the end of the period would have remained unchanged at $100 while the capital would have been adjusted to $200 and the loss of $100 in real purchasing power would have been recorded.

Some special consideration needs to be given to the effect of this procedure on fixed assets, since the special problems of fixed asset accounting make it harder to see the exact effect of the adjustments.

Depreciation Accounting

Some insight into the nature of depreciation and the effect of restating it in terms of current values or adjusted original values can be obtained by considering briefly the economist's approach to depreciation. The economist, unlike the accountant, normally looks to the future for his guide to values. He regards past costs or sunk costs, as irrelevant and insists that the cost of using an asset for a year can best be computed by computing the reduction in potential value that takes place during the year. In theory, in a perfectly functioning economy, the potential future value of a productive asset would be its market value. If this were the case, the depreciation for the year could be computed by measuring the decline in market values since this would reflect the decline in future productive value and thus would provide a reasonable measure of the cost of the productive value used up during the year. Since this is, in essence, what accountants are trying to measure by means of depreciation accounting, it is useful to consider why the results are not the same and whether this reflects a deficiency in accounting depreciation.

It appears that the differences are due to several complicating factors. These are:

1. The changes in specific or relative market values due to extraneous factors such as imperfections in the market, changes in relative values of the product and of the factors of production, technologi-

cal change and changes in the public demand for the product.

2. Changes in the general level of market values due to changes in the value of money itself.
3. Variations between the pattern of actual decline in productive value and the routine amortization of cost through depreciation.

The first difference, the exclusion from accounting income of specific or relative changes in the market value of fixed assets, is done deliberately and usually with full recognition of its significance. This difference need not, therefore, be regarded as a serious defect in accounting income. As was pointed out above, the use of current market value would involve the recognition in income of these elements of fortuitous or specific market fluctuation. The use of adjusted historical cost, on the other hand, produces a value for the asset and for the depreciation charge which reflects what the market value presumably would be if no changes in market values had taken place other than those due to inflation. This does not mean, unfortunately, that the use of conventional depreciation methods adjusted for price level changes will produce a measure of the productive value used during the period. The variation between actual declines in future productivity and straight line depreciation are too great. If, however, the accepted view of depreciation is abandoned and its similarity to rent is recognized by calculating it with due regard to the time cost of money, the decline in net asset value will begin to conform to reality. This, however, is also another problem not immediately related to the problem of accounting for price level changes.

Other problems in connection with fixed asset accounting can be dealt with fairly quickly. First, it should be pointed out that the use of adjusted historical cost does not obviate the need to review fixed assets in the light of market conditions and to recognize by appropriate write-offs any significant and permanent loss in productive value due to changes in technology or public taste. Secondly, since there is no intention of providing funds, no adjustment needs to be made for past or future changes in value. The historical cost adjustment aims to record the current cost in current terms. The fact that past depreciation charges are less than they would now be or that future ones may be greater does not affect the current year's figures. Any suggestion that depreciation charges are somehow related to the problem of financing future replacements seems to ignore so many other factors involved in this question that it cannot really be seriously considered. In any case, the adjusted historical cost method, by measuring the wasting of real capital due to inflation, gives management the information it needs to plan future financing.

Use of an Index

In the above section the actual conversion of costs into historical costs has been treated as if it were comparatively simple. In practice, of course, the choice of a suitable rate creates considerable difficulty and differences of opinion. Essentially, the difference lies between those who advocate the use of specific price indexes and those who recommend the use of a general index. The first group maintains that to adjust the historical cost of buildings, for example, the building index should be used and for machinery a machinery price index. It must be recognized, however, that the use of a

specific index will produce a figure which will approximate the "replacement cost" of the item in question. It will thus reflect not only the changes in the value of money itself but also changes in relative value due to market fluctuations, technical change and so on. The use of such a figure as the basis for determining income will, therefore, produce an income figure which will be closer to "economic" income than to accounting income adjusted for inflation. If it is desired to exclude the "unrealized" profits or losses due to changes in relative market values and other non-inflation items, an index which reflects only changes in the value of money must be used.

There is, of course, no actual "value of money" index available, at least in this country. A "general" index, however, because it represents weighted averages of different price changes, tends to neutralize the relative market fluctuations and to reflect only the basic change in money values.

Some theorists have advocated the use of the wholesale price index on the grounds that the items included represent normal "business goods" weighted in a business way whereas the consumer price index is related not to business purchases and sales but to private family consumption. It is doubtful if this argument is valid. The wholesale price index, although fairly broadly based, is, because it is restricted to trading commodities, subject to general fluctuations in level which are related not to the value of money but to general economic activity.

It would appear that, in general, the more widely based the index, the better it will reflect changes in money values rather than changes in the relative values of one or two commodities. The consumer price index is thus recommended by many authorities as the most appropriate. Since it measures the changes in purchasing power of a private consumer it presumably measures changes in that purchasing power. This index is thus used as the measure of changing money values more frequently than any other. It is, however, subject to some criticism because of its weighting. It does deal with only a small portion of the total economic activity —it emphasizes food, clothing and domestic shelter while it ignores productive equipment and facilities.

Fortunately, there is available an index computed on the broadest possible base. This is the "gross national expenditure implicit price index". This index is the one used to express gross national expenditure and gross national product in constant dollars. It, therefore, takes all classes and types of expenditure into account. Each class is weighted in accordance with its actual place in national spending patterns so that all fortuitous or relative price changes will cancel out leaving only actual changes in the value of money to affect it. At the present time, unfortunately, this figure is not published with the same frequency as the consumer index. This deficiency, however, would undoubtedly be remedied if it became known that business needed the figure.

Use of "Replacement Cost"

Before concluding, something must be said about the proposals which are made from time to time for the use of "replacement cost" as the bases for eliminating the effect of inflation. In those cases where the term "replacement cost" is used to mean *current* replacement cost, or in other

words, current market value, the use of this figure would be subject to the same objections as the use of current market, namely, that it involves the recognition of *unrealized* profits or losses resulting from specific or relative price changes as well as those arising from changes in the value of the dollar.

If replacement cost is used to mean the costs to be in effect at the ultimate date of replacement in the future, it will involve the recognition of profits and losses of this type as well as inflation profits which are not only unrealized but have not even occurred. It seems very doubtful if any significant income figure for the current year can be developed by taking *future* activities into account. However important it may be for a firm to plan the financing of its future capital expenditure, it is hard to believe that a charge to provide for such future needs is a legitimate factor in the computation of current income.

The conclusions to be drawn from the above seem to be:

1. The use of "replacement cost", in the sense of current market, as a basis for adjustment to the accounts will bring in the effect of fortuitous or relative price levels as well as those due to changes in the value of money.
2. The use of historical cost adjusted for changes in the value of money will permit the elimination of inflation without their disturbing side effects.
3. The use of a general price index produces a more satisfactory result than the use of a specific index since such indices come closest to eliminating the effects of relative or fortuitous price changes.
4. The use of "replacement cost" in the sense of future costs cannot be justified on any grounds but financial expediency.

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3. Recent Accounting Developments

R. D. Thomas, C.A.

We have been fortunate in Canada not to have experienced the dramatic changes in the purchasing power of our currency that has been the case in many countries. Possibly this is one of the reasons why there has been no strong pressure for our financial statements to take cognizance of fluctuations in the value of the dollar. This is not to say that there has been no pressure. In the anniversary lecture of the Quebec Institute delivered in November 1959 by Mr. Donald Gordon, the speaker called for an assessment of the situation and a definite statement of the views of our profession. Similarly, Eric Kierans, president of the Montreal Stock Exchange, has indicated the need for thorough examination of the implications inherent in our present approach.

Our profession has not shown itself unable or unwilling to change its postulates where there has been a proven need or altered circumstances. Part of the value of a review of what has been done in other countries is the stimulus provided for assessment of our own circumstances to determine whether there is yet a need for a change in our thinking.

What Has Been Done?

In summarizing some of the at-

tempts that have been made to have accounting statements reflect changing money values, it will be necessary to deal with other countries; for, without overstating the facts, it can safely be said that in Canada very little has been done.

There appear to be three major methods used in the approaches that have been made to this problem: government acton, action by individual companies, and research. The first two have produced changes in some published financial statements, the last has restated some published statements to reflect changing money values.

Government Action

Generally, government action was necessary for at least two reasons in most European countries:

1. Two world wars made large-scale rebuilding of physical plant and equipment necessary. Hence governments had to encourage their industries to invest large sums in renewal and modernization.
2. Rapid internal inflation made such rebuilding programs difficult.

Most governmental action took the form of providing tax incentives for investment in new capital assets. These incentives were given in many ways, the two most common being: a system of tax-free reserves and what was termed "revalorization", that is, the writing up of fixed assets on the basis of a general price index, usually prescribed by the government.

Governmental action will not be discussed further here since actions taken by individual governments were very often dictated by motives quite different from what might be termed "good accounting practices", and the methods used were often blunt, particularly when applied to the accounts of an individual enterprise.

Action by Individual Companies

Philips Company

For supporters of the replacement value theory for the calculation of income and capital, there have been some major "break-throughs" in published financial statements. Probably the most concerted attempt in this regard is the treatment given in its financial statements by the Philips Company, a large international industrial company with headquarters in Eindhoven, The Netherlands. The company constantly reviews its assets and costs and revalues, by means of index numbers, those for which significant price changes have occurred. These index numbers are built up by a pooling of the experience of the purchasing, personnel, costing and economic analysis departments.

In dealing with fixed assets, the company maintains fixed asset accounts at replacement values, accumulated depreciation accounts at replacement values, and revaluation-surplus accounts. If a price increase occurs, the fixed asset accounts at replacement value are increased and the fixed asset revaluation-surplus accounts are credited with the increase. An increase in the charges for depreciation is also calculated to allow for the new price level.

If the price level of a fixed asset decreases, the reverse procedure is used, provided the company has firmly

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established that the decrease is the result of a change in price level and not from other economic or technical reasons. In the latter cases, the decrease would be charged to operations and not to the revaluation-surplus accounts. Should a revaluation-surplus account become exhausted as a result of charges due to price decreases, then the adjustment of the replacement value would be charged to operations since the company does not allow revaluation accounts to show debit balances.

In a similar fashion the index numbers are absorbed into the inventory accounts to reflect changing standard prices. However, in dealing with goods manufactured in its own plant, a further refinement has been adopted by Philips. With these goods, there is the possibility that the trend in prices has also been affected by changes in technology and efficiency in the company's plants. For example, an improvement in efficiency would have a retarding effect on an increase in price levels. The element of price decrease resulting from increased efficiency is charged to operations and not to a revaluation-surplus account.

In accordance with the accounting principle that only realized profits are to be reflected in the accounts, inventories are never revalued above the amounts at which they can be sold at a profit.

Imperial Chemical Industries Ltd.

An interesting example of another treatment in dealing with this problem is that revealed in the financial statements of Imperial Chemical Industries Limited. In 1950 the company wrote up the values of its depreciated fixed assets and adjusted its annual profit figures accordingly. The value of the fixed assets recorded in the balance sheet is the depreciated current cost having regard to the age of each asset, not the full cost of replacing the asset as new. This depreciated current cost was computed by engineers and accountants in collaboration.

In accordance with the British practice of crediting depreciation provided direct to the asset accounts rather than to separate accumulated depreciation accounts, ICI wrote up its capital asset accounts as at January 1, 1950 to the computed depreciated currrent cost as at that date. The credit arising from the revaluation was credited to a capital reserve. The total of £96,000,000 represented more than 100% of the original cost of the assets.

As part of the accounting and engineering studies necessary for this revaluation, a careful analysis was made of the length of the useful life of each separate classification of plant and equipment. Annual depreciation could then be calculated separately for each item by dividing the new present value of the plant and equipment by the number of years of useful life remaining.

To assist in retaining funds for replacement of the difference between the values of the assets in their new and their used condition, the company decided to supplement the depreciation charge computed on the new basis by an additional reserve to be built up by appropriating out of profits each year an extra amount as appeared desirable on the information available. In 1950 the amount appropriated was £5,000,000, credited to capital reserve as a reserve for obsolescence and replacement of assets. At the end of 1957 this reserve had risen to £50,000,000. Unfortunately,

beginning in 1958 this reserve was not separately identified from other general reserves of the company so that it is impossible to determine the up-to-date figures.

It is interesting to note that in 1958 the company again revalued some of its fixed assets, which had an original cost of £259,000,000, and as a result there was a further credit to its surplus on revaluation of nearly £67,000,000.

These entries indicate the effect of inflation on the position as reflected by the annual statements. The consolidated profit and loss account at Imperial Chemical Industries Limited and its 93 subsidiaries for the year ended December 31, 1949, contained a charge of only £6,600,000 for depreciation, whereas the charge for the following year was £8,700,000, an increase of over £2,000,000, or about 30%.

United States Steel Corporation

Another example of individual company action was that of the United States Steel Corporation which, in 1947, made an extra charge against profit of $26,300,000 to "cover replacement cost", and a note to the accounts said: "The added amount is 30% of provisions based on original cost, and is a step towards stating wear and exhaustion in an amount which will recover in current dollars of diminished buying power the same purchasing power as the original expenditure . . . the 30% was determined partly through experienced cost increases and partly through study of construction cost index numbers."

Throughout the first three-quarters of 1948 the company continued to make a charge for additional replacement cost at the increased rate of 60%. However, at the year end, apparently as a result of action by the Securities and Exchange Commission and the American Institute of Certified Public Accountants, the company changed to accelerated depreciation while still affirming its conviction of the correctness of its former position.

It would appear that the steel industry still believes that the stand of U.S. Steel was correct, for a press release in December 1959, explaining the industry's position in its industry-wide steel strike, stated as follows:

"The industry's contention was that under conventional accounting, depreciation is calculated based on the original dollar cost, and that this is inadequate because it fails to give effect to the tremendous change that has taken place in the purchasing power of the dollar, as a result of which it would cost many more dollars today to replace the plant than were originally spent. The industry maintains that realistic profits should be figured by reference to replacement figures. On that basis the industry's profits are one-half of what the financial statements show."

Research

A valuable study by Professor R. C. Jones was published in 1955 by the American Accounting Association. Professor Jones took the financial statements of four U.S. companies: the New York Telephone Company, Armstrong Cork Company, The Reece Corporation, and Sargent & Company, for years ranging from 1940 to 1952 for the New York Telephone Company and 1929 to 1952 in the case of the Sargent Company and restated them in constant-value units. It was necessary to restate all figures in terms of constant-value units, and

the units used by Professor Jones were 1951 dollars as adjusted by the Consumers' Price Index of the U.S. Bureau of Labour. Using the New York Telephone Company's depreciation for 1946 as an example, the amount recorded in the accounts was, in round figures, $28,000,000. The amount, according to a statement, adjusted fully for the years of acquisition of the fixed assets was $47,000,000. The latter amount, however, is expressed in December 1951 dollars and therefore could not be compared with the $28,000,000 which must be presumed to consist of 1946 dollars since it is deducted from the 1946 revenues. Professor Jones made the adjusted and book depreciation figures comparable by multiplying the book figure by a factor, 1.356, representing the purchasing power of the 1946 dollars in terms of the December 1951 dollar. This indicated that the book depreciation converted directly into 1951 dollars was $38,000,000 which could be compared with the $47,000,000 representing the adjusted depreciation computed in constant-value units by years of origin and expressed in December 1951 dollars. Thus a deficiency of approximately $9,000,000, or almost 19%, is disclosed when all amounts are measured in dollars of the same size.

An important figure in public utilities is the return on investment. According to the book figures, the New York Telephone Company earned an average of 6% from 1946 to 1952. However, if these figures are adjusted to reflect the declining value of the dollar, the average return on investment was only 3% for this period.

Equally dramatic differences are disclosed in comparing the results of operations of the Armstrong Cork Company which had an average earning rate on investment for the years 1941 to 1951 of 8.8% as indicated in the published statements. If these published figures are adjusted for price level changes, the average rate of return falls to 4.5% since the adjusted net earnings were only $59,000,000 as compared to net earnings as shown on the statements of $92,000,000. In this same period, Armstrong Cork paid income taxes at the rate of 47% of net income using the published figures but 58% of net income using adjusted figures. The company, according to its published statements, paid out 56% of its net earnings in dividends; the adjusted figures indicate that it paid out 89% of its net earnings to its shareholders.

While the above results are an impressive indication of the corrosive effects of inflation, they are not unexpected since the 10-year period covered was one of consistent inflation. The case study of Sargent & Company is the only one of the four that covers years of both deflation and inflation. For this company the net loss in the deflationary years, when computed in dollars of uniform purchasing power, was only half as large as the net loss as computed in historic dollars; for the inflationary period the net income was less than a third as large as that computed in historic dollars. In the deflationary period depreciation actually charged was approximately equal to depreciation measured in uniform dollars while in the inflationary ten years it was nearly $1,000,000 less than depreciation measured in uniform dollars.

Similar differences are reported in the study of the Reece Corporation. An interesting result of this case

study, however, is that in its 72nd annual report for the year ended December 31, 1953, this company, using data gathered in Professor Jones's price level study, presented an analysis of its capital and income measured in dollars of uniform purchasing power. It would appear to be the first U.S. company to include such information in its annual report.

Conclusion

It is hoped that this brief résumé of what some companies and countries have done about the problem of accounting for different values of the money in which financial statements are expressed has given an indication of what can be done. To those who say that our financial statements in Canada should reflect changing price levels, the answer can be given that the changes in our dollar have not been sufficiently severe to warrant adding the subjective complications that would be required. To those who raise these objections, answer can be given that with intelligence and experience the subjective elements in the problem can be reduced to a body of accepted practices no different from those with which we now deal. It is more than time for the Canadian accounting profession to study this problem in depth and, whatever its conclusions may be, express itself on this issue.

In the absence of any pronouncements or "generally accepted principles", those companies interested in pursuing this matter in presenting their financial information, either for internal or external purposes, might take a leaf from Professor Jones's study and produce both historical cost statements and comparative results with statements adjusted for differences in the purchasing power of the dollar. Their experience would be valuable in the profession's search for a pronouncement and, if one or two large companies took the lead, might also solve the problem of whether this method of accounting can ever become "generally accepted" in Canada.

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Accounting Research

Disclosure in Financial Statements

A large part of the effort of professional accounting bodies, in Canada and elsewhere, is devoted to the study of "standards of disclosure". This emphasis on the need for using financial statements as a means of disclosing information, rather than concealing it, is a natural and proper one for bodies whose primary concern is the fairness of management reports to corporate shareholders. There is no doubt that a great deal of good has come from the increased attention paid to this subject in recent years, and that a closer conformity to existing standards would eliminate most of the remaining causes for complaint. There is, however, substantial evidence that there exists a continuing, more basic dissatisfaction which would continue even if all current standards were met.

As these basic dissatisfactions are very general in nature and reflect a vague feeling that financial statements *could* be more useful, specific suggestions or proposals for further improvement are unlikely to come from the users themselves. This follows naturally from the fact that the increasing complexity of accounting problems has reduced the number of users who can understand the difficulties involved well enough to suggest specific, practical solutions. The accounting profession, therefore, although it must not ignore the evidence of user dissatisfaction, must make its own analyses of the problems and propose its own solutions. This means that if improvement in financial reporting is to continue, accountants must give more consideration to the real needs of different classes of users and make a greater effort to evaluate present and proposed practices in the light of these needs.

This idea is by no means new. Accountants have always recognized the needs of the user as one of the criteria by which financial reports should be judged. It is not so certain, however, that this standard is always applied carefully and consistently or that the real needs of users have always been precisely evaluated. In fact, present inconsistencies and inadequacies in financial reports suggest that in many cases the real object of the reports has been overlooked.

As an illustration of the way in which a reconsideration of the purpose of financial statements can give new insights into problems of disclosure and provide a consistent basis for the evaluation of existing and proposed practices, an analysis of some current problems has been prepared. This analysis should not be regarded as official or even complete since it represents only one possible approach to a problem on which there seems to be little agreement. In the same way, none of the proposals discussed should be regarded as anything more

than tentative subjects for discussion. It is hoped, however, that the rather extreme nature of some of the disclosures advocated will at least direct new attention to the unresolved problems.

It is assumed in the discussion which follows that the needs of both present and prospective investors are essentially the same, since the decision to hold or sell must be based on the investor's appreciation of future prospects in exactly the same way as the decision to invest in the first place. If this is the case, it then follows that the primary need of users of published financial statements must be for data on which reasonable forecasts can be based. In the following sections the implications of this view of financial reporting on the statements are discussed.

The Income Statement

One of the few figures which both investors and accountants seem to agree are needed but which is not usually available is the sales figure. It cannot be denied that this figure is an essential minimum of disclosure, and it is difficult to understand why so many companies refuse to disclose it. A further consideration of the basic use to which this figure is to be put, however, suggests that, in itself, a dollar figure of gross sales will not help particularly. No one can draw intelligent conclusions from a change in dollar sales volume without knowing whether the change is due to a change in price or a change in quantity. It, therefore, seems to be essential to provide some means for segregating these two factors. In some situations this can be done by providing figures in terms of physical volume as well as dollar volume. In many situations, however, this will not be practical and a more indirect method of disclosure will have to be used; for example, a figure for sales at last year's prices can be provided, or the approximate weighted average percentage change in selling price might be quoted.

Even this degree of disclosure will not be adequate if the company's product lines are very diverse or if they consist of several different classes of product. In the former case it may often be impossible to do more than distinguish changes in revenue due to actual changes in price from those due to changes in product mix. In the latter case, however, a proper evaluation of prospects would require the provision of separate revenue figures for each of the main classes of product. If this information were given in all relevant cases, the analyst would be able to make reasonable forecasts in a way not now possible even in the minority of cases which give total sales figures. Although it may be argued that the provision of general data for the industry as a whole is not the responsibility of an individual management, no doubt such information is very helpful in those cases where it is now made available.

Since the principle object of the average investor's forecast would be the net profit figure, the provision of the sales figure alone would not be sufficient. It is, therefore, rather surprising to find very little criticism of the present methods of reporting expenses. It is true that the advocates of "direct costing" emphasize the need for dividing expenses into fixed and variable categories. They have not, however, given much consideration to the problems of disclosing these results in published accounts. A discussion of the merits or demerits of the direct costing pro-

cedure is outside the scope of this article. It is, however, unnecessary to accept the direct costing approach to inventory values in order to recognize the importance of this classification to the forecasting procedure.

No matter how detailed the revenue figures and how careful the revenue projections, no reasonable estimate of net profit can be prepared unless the relationship between costs and volume can be determined. Even in those companies which are not in a position to segregate all their costs into fixed or variable categories, a considerable improvement in reporting could be achieved. Most companies, for example, could at least show the cost of goods sold separately. In most cases this would permit the adjustment of the major portion of the manufacturing cost for expected changes in volume. A similar segregation should also be possible in respect of distribution costs which, even if not entirely variable with sales, are usually more closely related to that figure than are the balance of the general and administrative costs. To be of maximum benefit some indication of the effect of price changes during the year should also be provided, at least for such major items as wages where a single contract negotiation can make a significant difference in total costs.

As a result of professional recommendations and legal prescriptions, most of the remaining items which are needed for forecasting are normally segregated at present. These include interest on funded debt, depreciation and so on.

There are, however, some items not at present segregated which it might in some cases be desirable to show separately. Perhaps the most important is the amount of the annual charge in cases where long-term leases have been used as a substitute for conventional financing. This amount, like bond interest and depreciation (for which it is to some extent substituted) is a fixed charge which, if material, can have a profound effect on the margin between gross and net profit. It is also possible that depreciation data would be more useful if broken down between cost of goods sold, distribution costs etc. than lumped with depletion (and other amortization items) in one sum.

The provision of additional information to the extent suggested above would really produce a revolution in financial disclosure. With such data it would be possible to compute fairly significant trends for revenues as well as for the cost of goods sold, distribution costs and other items, and from these trends and general economic data to produce a picture of the future which would be a really rational basis for investment decisions.

The Balance Sheet

It is now generally agreed by accountants that the income statement is the principal accounting document and that the balance sheet is relatively unimportant. In practice this means that accountants do not hesitate to abandon balance sheet significance if, as in the case of *Lifo*, such abandonment seems to be required by a procedure which increases the usefulness of the income statement. Fortunately, however, the balance sheet has not, in practice, been altogether abandoned. In fact, the greater part of most professional pronouncements on matters of disclosure has related to this statement. As a result, the details and descriptions given in the average balance sheet

are probably as informative as can be expected.

The adoption of the need for forecasting information as the basic test of the adequacy of financial data would not change the relative emphasis on the income statement. Intelligent projection of the future requires a reasonably detailed knowledge of the nature of the company's assets and liabilities, especially the amount of working capital; the debt retirement obligations; changes in the investment in fixed assets and so on. Such information, in addition to giving a picture of the business, is necessary for the preparation of past and future cash flow forecasts.

The trends observable in many balance sheet ratios are useful guides to the probable course of the future. Such measures of managerial efficiency as accounts receivable turnover and inventory turnover are often the first indications of a change in operating patterns. The presentation of enough information to permit these calculations to be made accurately is therefore quite important. In most companies this will mean a breakdown of inventories into major categories(by product class and by stage of manufacture) and in some a similar analysis of accounts receivable to match the classification of sales.

By far the most important ratios, however, are those which measure the actual efficiency of the management or the profitability of the enterprise, that is, the various return on investment calculations. Unfortunately, under present conditions, the gap which has developed between present values and book values of fixed assets is so great that the rate of return ratios are of only historical interest. Most of this "gap" is due to the inflation of recent years, but it should not be forgotten that inaccurate depreciation policies have also played a part.

If these variations could be eliminated by the development of some procedure for adjusting the accounts to eliminate the effect of inflation and if depreciation procedures could be rationalized, the rates of return on total debt and equity and on equity alone would have profound significance. The rate of return on a total investment which approximates present values would not reflect the profitability of the original investment in the conventional way, but it would show it in terms of equivalent purchasing power. Because it would tend to show the profitability of the enterprise in terms of present values, such a ratio could be a very valuable guide to future developments. A company which is earning an above-average return *on present values* can expect to stay competitive against new entrants and also to remain competitive even after it has been forced to replace its assets. The numerous companies which show a fair return on a historical cost basis but which would not do so if profits were compared with present values are, on the other hand, really dissipating their resources and will find themselves in trouble when assets come to be replaced.

The best solution to the problem of presenting current values in balance sheets would no doubt be the revision of our accounting practices, especially since this would correct the corresponding depreciation error in the income account at the same time. However, need for this information is so great, and the difficulties in the way of revision so complex that some interim measure seems to be called for. This might involve, for example, the provision of estimat-

ed present value or current dollar value statements as a supplement to the regular accounts. That such figures are often provided in prospectuses suggests that the value of the information is recognized and that it can be obtained.

In this area too, the unresolved problems posed by long-term leases are significant. If the measure of efficiency or profitability is considered to be the rate of return earned on assets employed in the business, information regarding the assets controlled through long-term leases is obviously significant. More consideration must, therefore, be given to the problem of finding an acceptable method of reflecting the assets "acquired" by this method and of showing the related obligation.

Conclusion

Although the above discussion has been put forward more "for the sake of argument" than as a practical proposal, it is submitted that any satisfactory solutions to the problems of financial statement disclosure, although not necessarily the same as those proposed, will be at least as revolutionary. Unless accountants recognize this and face the possibility that present practices are not sacrosanct, the increasing dissatisfaction with some of the results of contemporary accounting may lead to unfortunate results.

We accountants complain that our critics do not understand what we are trying to do. We excuse the failure of conventional statements to provide the information necessary for making intelligent forecasts on the grounds that this is not the purpose of the statements. Unfortunately, we all too seldom ask ourselves what this purpose really is and whether it is socially useful or necessary. If we did ask this question more often, we might recognize the very real danger to accounting which is implicit in its present failure to meet the needs of many users of financial data. There is always the possibility that someone else will develop a way of doing what we are failing to do. If this comes to pass, accountants may well find themselves engaged in weaving elaborate webs of theory and principle which, although logically consistent and intellectually satisfying, nevertheless bear little relation to reality.

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Practitioners Forum

AUDITING SMALL BUSINESS — II

This month's column consists of some highlights from the challenging remarks made by Irving L. Rosen, C.A., at the Ontario Institute's 1960 Annual Conference. His paper was a companion to Mr. Walker's which was published in the November 1960 column. Mr. Rosen dealt with "interim accounting practice for the small and medium-size client".

Many small businesses have weaknesses in internal control due to the limitations imposed by the amount of control which they can afford. This type of client will be considered here. Such a business usually has an office staff limited both in number and quality and is usually managed by the owners. The owners are generally capable and highly skilled craftsmen, manufacturers or salesmen who are anxious to make profits and reluctant to pay audit fees. Their concept of reducing unnecessary costs involves lower office salaries. They are frequently "busy" and unavailable when the accountant is working on the figures.

When they recognize the benefits of accounting services and are sold on the truism that decisions based on facts are more profitable than decisions based on guesswork, they become highly cooperative clients. Not only does their respect and demand for the accountant's advice grow, but there is a lessening of their resistance to fees, commensurate to the services rendered.

Accountant's Role

The year-end balance sheet or "undertaker" audit, where the accountant comes in only after the year is over to do the audit, is one of the services less useful to this type of client. Services, to be of maximum value, must be rendered in time to forewarn management of impending weaknesses, to reverse low profit margins and high costs, and to prevent poor financial planning.

The auditor becomes the navigator of the small business. Interim audit procedures must be supplemented and adjusted to embrace the management services which are demanded of him. Audit procedures designed for clients who have good internal controls and a responsibility to the investing public are not necessarily appropriate where management and ownership are the same. Small business audits must be made with a twofold purpose in mind, for we have two roles to play: those of independent auditor and of management or business consultant. Accountants who feel that these two roles conflict should not be surprised when the small client turns elsewhere for needed advice.

Many current articles in accounting magazines on such topics as intricate systems of internal control, reliance

on other auditors, accounting for inflation and income tax allocations, cover academic matters as far as small business is concerned. However, topics such as management services, tax planning, budgeting, bookkeeping, cost accounting records, determination of prices, financing and training of staff cover matters of real concern.

Although the relationship with the client is usually very close, friendly and confidential, chartered accountants are still governed by the general principles and rules of their profession. Their position often involves an indirect responsibility to third parties, such as the bank or Taxation Division, who rely on financial statements they have audited or prepared. As Professor W. G. Leonard of Queen's University has stated: "The auditor must not skimp the quality of work on jobs where the fee is small or submit to the subtle temptation of assisting important clients by mirroring the clients' wishes rather than insisting on clear disclosure." Independence is a mental attitude and can be retained as long as the auditor's freedom of mind and action has been maintained, even though the accountant may be close to his client and do the client's bookkeeping.

Audit Approach

Other factors besides internal control have a bearing on the auditor's approach. One is the type of business. For example, in a construction firm, stress is placed on accurate costs; in a retail or wholesale operation, sales receive more attention.

Another factor is the condition of the records. If the auditor keeps the records, certain audit procedures can be attended to when the books are written up. For example, disbursements can be vouched and classified when the cheques are entered.

The nature of the engagement will also be a factor. If the client does not want an unqualified opinion, then a restricted audit can be carried out. This may not be sufficient in scope to allow the auditor to render an opinion but may enable him to take off a financial statement that he feels is reliable. In this case, he should state clearly that he is not giving an opinion and outline the limitations of his examination.

A further factor governing the nature of the examination is the auditor's ability, judgment and perception. A great deal depends on the auditor's knowledge of the client, his records, business and staff. This knowledge enables the auditor to determine the weak spots and potential trouble points.

Detailed Examination

Some accountants consider the detailed audit to be a relic no longer of use in practice. This is not so. The detailed audit is one step above the bookkeeping engagement and serves a necessary and useful function. It is appropriate:

1. when the records are kept by a person having little knowledge of bookkeeping principles;
2. if the bookkeeper is careless and prone to error;
3. if there is a high degree of risk and inadequate internal control;
4. if the owner cannot be relied upon to provide an independent check;
5. when the client wants a detailed check on the office staff;
6. when the client is not so large that the audit fee for a detailed check would be exorbitant.

Sometimes this type of audit is per-

formed when the auditor's staff is at a junior level and it is felt safer to perform a detailed audit than to chance that the staff is overlooking significant errors in a test audit.

The bookkeeping engagement is similar to the detailed audit except that the accountant is recording the entries directly, either completely or in part. It is often found that the client can be taught to record sales, payrolls, cheques, accounts receivable and accounts payable.

If the auditor ends his duties with the preparation of a trial balance, he is depriving the client of services and benefits to which he is entitled. The accountant becomes only "the man who checks the books". The accountant's knowledge, experience, insight and professional abilities have not been fully used. In these circumstances, he has only himself to blame if he does not obtain the professional fees desired and the respect and confidence of the client.

Testing Records

In the test audit of auditing transactions, the auditor must determine to what extent he can rely on the internal control that is in effect. Great emphasis is put on the auditor's personal knowledge of the business and his ability to resolve any points that might prevent him from rendering an opinion.

The least imaginative test audit is one in which every other month or one month in three is checked. This is merely a step beyond the detail audit and may involve little additional mental effort. "Test" implies that the auditor can safely rely on the principles of sampling. The purpose of testing is, by checking through important representative transactions, to determine to what extent the internal control is really effective. This means that the auditor must train his staff to pick out and follow up significant items. Not only is this type of audit more efficient than a detailed one, but it is also less boring to audit staff and prevents them from feeling their only duty is to put their audit stamp on every invoice in the office.

Administrative Advice

Too little use is made of budgets, graphs, ratio analysis and direct costing; yet they can be of considerable aid in the interim administrative audit. This may be a sign that the auditor has not developed beyond the detailed audit stage. Management may be losing the benefits of financial controls because the auditor has not sold it on the use of budgets and similar techniques.

Small and medium-size clients and their auditors customarily place greater emphasis on monthly or interim audits than do large clients and their audit firms. The year-end audit is considered less useful as an aid to operations. Management is interested in what is happening currently so that necessary action can be taken in time to improve results.

The auditor's services are in demand continuously. Should new factory equipment be purchased? Is there any need for another office girl? What should be done about delinquent customers? What will be the effect of a wage raise? What are the tax aspects of a proposed deal? Should the bank be informed of the current position? Questions like these require advice, opinion and interim financial statements. To be in a position to supply the information needed, the auditor finds it necessary to emphasize the importance of interim audit work so that his advice is based

on figures that he knows are reliable. The year-end verification becomes only another aspect of a busy year's work, and not the highlight.

Interim Reporting

Usually interim financial statements are prepared by or under the direct guidance of the auditor. It is not usual to find an extensive scope paragraph or any opinion attached to such statements. A long interim report is seldom prepared as any discrepancies, weaknesses or recommendations are discussed verbally with management and any features of note are covered in a letter.

The auditor's report can vary in extent from "Prepared from the books without audit" or "This report is submitted for the guidance of our client and is not intended to be used for any other purpose" to the regular opinion recommended in Bulletin No. 17 of the Canadian Institute. Some firms prepare no interim audit report at all, and type the financial statements on the auditor's stationery without comment.

There is room for new types of audit reports that could be given official Institute approval. The scope paragraph could mention the auditor's part in the record-keeping. As an alternative to "We have examined the balance sheet of X company", perhaps a more accurate statement would be "We have prepared . . .".

Many accountants feel that the wording "Prepared from the books without audit" is not only misleading but is also poor client relations and public relations. This label could mean that only a clerical typing job was performed. In most cases, interim statements are prepared after a certain amount of checking and the accountant is reasonably satisfied that the figures are correct. Because certain year-end work such as attendance at stock-taking and direct confirmation of balances has not been completed, there is no reason to feel that the statements are incorrect. Clients are likely to resent any inference that something is wrong.

The following scope paragraph is suggested as an alternative:

"Our examination of the financial records of the company was made mainly for the purpose of furnishing a report for the use of management on the financial position of the company at June 30, 1959 and the results of operations for the six months then ended. The scope of our work on this interim examination did not include the normal year-end verification of assets and liabilities, and an opinion will not be rendered until the year end."

Recommendation

There is a need for a "Committee on Practical Problems of the Small and Medium-Size Audit". In Ontario, of the 330 firms in public practice in January 1959, 250 had less than 10 chartered accountants and students. Of the 1,400 chartered accountants in public practice, some 900 were in these small and medium-size firms. This indicates that the problems of the small and medium-size client affect the majority of accountants in public practice. Nevertheless, there is very little authoritative literature to guide the practitioner as to the procedures necessary to meet the problems of such clients, for example, when there is inadequate internal control.

The provincial Institutes and the practitioners in small firms are both to blame for this surprising inertia in

a very important field. The Canadian Institute has failed to provide the leadership and initiative necessary. But can it be blamed when the majority of small practitioners seem to be blissfully unconcerned about what happens?

There is no doubt that a "Committee on Practical Problems" would have enough questions to keep it busy. It would be useful, for example, to determine to what extent the approaches of the large and small audit firm differ in the audit of the small client. The extent to which the auditor should double as a management consultant is another aspect worthy of consideration. New philosophies of auditing may be necessary when the audit of a business is dependent upon checking rather than testing, and upon personal knowledge rather than routine approaches. Such a committee could stimulate its members and others to write more articles on such subjects and so extend the amount of literature available. Eventually bulletins or case studies could be compiled.

Mr. Rosen has prepared a very stimulating and thought-provoking paper. Are we facing up to the opportunities and challenges that exist in this area?

NEW ZEALAND

Last spring the New Zealand Society of Accountants held its 60th anniversary convention in Wellington. Approximately 700 members and wives registered. There were 26 visitors from overseas including the editor of Practitioners Forum.

The advance preparation for the convention was very thorough. Extensive papers on the topics to be discussed were prepared, printed in booklets and mailed to all registrants in advance. At the sessions, half a day was allowed for each topic. A chairman introduced the panel, which consisted of a rapporteur, the author of the paper and four commentators, usually including one from overseas. The rapporteur summarized the paper, the commentators then made their remarks and the author replied. After a break for tea there were a panel discussion and a general discussion. Finally the rapporteur summed up.

Overseas conventions are extremely interesting because one meets many people of varied backgrounds. On the other hand because local conditions are considerably different from the Canadian scene, the topics are less likely to be of direct interest than those of a Canadian convention.

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Tax Review

Canadian Tax Foundation Conference

The 14th tax conference of the Canadian Tax Foundation was held in Toronto in the middle of November. Among the more important topics of discussion were sessions on "Investment, Savings and Taxes" and "Corporate Surplus". In dealing with the former, Mr. Harvey Perry, the director of the Foundation, pointed out that the credit granted to individuals receiving dividends from Canadian corporations was originally intended to stimulate the purchase of equity securities by Canadians. This credit has not achieved the desired results, he stated, because the corporate tax advantages of financing through bonds, debentures and other types of loan capital have more than offset the advantages accruing to individuals on the receipt of dividends instead of interest. The individual shareholder has been an unequal contestant in the struggle for capital. Accordingly, his desire for dividends or equity securities has been ignored, to a large extent, by the corporations who much prefer loan capital.

Mr. Perry also pointed out that the tax system has tended to produce a massive aggregate of savings in the hands of institutional investors which do not, as a general rule, produce any great source of venture capital. He felt, therefore, that savings should primarily be in the hands of individuals in order that the necessary aggregate of risk or venture capital would be available. It was Mr. Perry's opinion that some tax concessions should be granted which would encourage an increase in dividend payments to Canadian individuals. He suggested that one means of accomplishing this would be to allow corporations to deduct from taxable income the amount of dividends paid to Canadian shareholders. This proposal is somewhat akin to the one made recently in these pages concerning the exemption from tax of dividends received by individuals, and it may be more palatable to the government from a political point of view. It would, however, result in a greater net loss to the Treasury than if dividends were exempt in the hands of individuals, unless there was a differential in the rate or in the amount to be deducted.

The president of the Montreal Stock Exchange, Mr. Eric Kierans, stated that "Growth of our own savings should be the most important single aim of internal policy and I consider it to be more important to devise the measures to accomplish this objective in the personal rather than the corporate sector." It was pointed out that corporations tend to finance out of retained earnings instead of going to the market with new stock issues. While this policy had certain advantages from the cor-

porate viewpoint, it was felt that it was not economically sound as far as the country as a whole was concerned.

Scottish Heritage of Caution

An economist, Mr. H. A. Hampson, also suggested that corporations should be permitted to deduct from taxable income dividend payments to residents of Canada. This plan, he suggested, would kill three birds with one stone: it would encourage Canadian subsidiaries of foreign companies to offer common stock to Canadians; it would reduce the $400,000,000 a year fund of retained earnings being built up by foreign investors; and it would require more companies to face the stock market to raise the capital they considered necessary for expansion. Mr. Hampson said that the continued growth of foreign ownership of Canadian industry was both puzzling and worrying. In large measure it was caused by a lack of initiative on the part of Canadians and by a heritage of Scottish caution witnessed by the fact that Canadians were the most heavily insured people in the world. He criticized Canadian individuals and, more particularly, life insurance and trust companies for being far too conservative, investing only a fraction of their accumulated savings in common stock and the bulk of that in industries which were mature, stable or declining. The whole problem of foreign domination or ownership and the lack of venture or risk capital is becoming a very serious problem, and any measures that the government can take to counteract the trend and give Canada back to Canadians should be sought and encouraged even though such incentives might not appreciably change the habits and characteristics of the Canadian people.

Two Headache Remedies

In dealing with corporate surplus it was forcefully pointed out that the Income Tax Act has become too complicated and too restrictive. The sections dealing with designated surplus, while sensible in intent, merely cause corporations and individuals to devote a great deal of unproductive time in avoiding a tax which was so punitive that it would only be paid through inadvertence. Mr. D. J. Kelsey, C.A., suggested that there were two possible avenues to remove some of the headaches from the tax laws regarding corporate surplus, which he termed "a particularly complicated, controversial and frustrating segment of our tax law". First, the Act could be patched up to try and prevent surplus accumulations from escaping the tax net, but he pointed out that, with ingenuity, taxpayers would likely still find loopholes.

He thought that the simplest way would be to follow the example of Mexico, where a special tax was paid by corporations on distributable profits in lieu of a personal tax on recipients of dividends or other corporate distributions. This tax, if imposed, would then permit shareholders of Canadian companies to receive dividends free of tax. Despite arguments that this move would not be politically acceptable (and this is probably true), Mr. Kelsey felt drawn to "the simplest solution of all; tax corporate income heavily as it flows into the corporation and thereafter let the residue of earnings pass freely among residents with neither tax nor hindrance from tax laws". It was his feeling that this simple device would provide incentive for Canadians to save by way of ownership in Canadian resources and endeavours and would tend to solve, although not

completely, the problem of foreign ownership.

* * * *

More on Exempting Dividends

There has been more response from readers of the November issue of the Tax Review than any recent issue. It would appear that the suggestion to exempt from tax dividends received by Canadian residents from taxable Canadian corporations appeals to more people than those who would stand to benefit directly. As indicated above, the suggestion was advanced at the tax conference of the Canadian Tax Foundation, and it proved to be a very stimulating topic.

It is quite apparent that the prospect of exempt dividends is thought-provoking, particularly as many people seem unsure of the economic consequences, whereas there is considerably less diffidence in opinions on the political implications. Since the issue remains a lively one, it would seem appropriate to review some of the more common arguments against tax-free dividends in order that both sides of the issue may be covered. This is not to suggest that the editors cannot make up their minds, but rather that certain of our readers have taken exception to some of the arguments advanced previously.

Readers' Reactions

One of the advantages attributed to the proposal was that it should induce the public to demand equity capital and to provide risk capital. If dividends were exempt from tax, it is reasonable to assume that it would be an inducement to individuals to invest more heavily in equities. It is not possible, of course, to predict the likely response to the inducement particularly in view of the statement that Canadians are far too conservative in their investment habits. For example, many people who purchase common stock are less interested in the dividends that may be received than the prospects for growth. Appreciation in the value of capital stock of public companies generally can be realized by selling the shares. For those taxpayers in the lower tax brackets, to whom investment income after tax may be a very important consideration, it would appear that by and large they are conservative investors. It is likely that even if they were to reduce their holdings of bonds to acquire equities, it would not be the equities of companies in businesses with a high degree of risk that would attract them. Moreover, the short-term effect of such a conversion on the bond market might be disastrous.

A problem which is discussed in conjunction with dividend policies are those companies which have more retained earnings than they require for their operations and which, if distributed, might be reinvested to better advantage in other companies. It has been suggested that tax-free dividends would be the key to unlock such treasure chests. Whether this is so would depend upon why the earnings were being retained; in many cases it is not the tax cost of a distribution that is a determining factor.

It was observed that " . . . since corporations do not get a deduction for dividend payments, the amounts received by shareholders have already been effectively taxed". A reader suggests that this is debatable. There would appear to be evidence which demonstrates that corporate taxes do not reduce income that would otherwise go to shareholders but are passed along to the customers. Accordingly, corporate taxes are just another

element of the cost of doing business and cannot be said to be borne by the shareholders.

While this may be true to a certain extent, might it not also be said that the personal taxes of shareholders also are borne in the long run by the customers of the company? In the competition for capital, the effects of one type of security over another upon the shareholder and the corporation must be considered. Once this factor has been established, the corporation must ensure that it has enough revenue to service the debt. If dividends were exempt from tax, corporations might feel that they could pay smaller dividends to the shareholders because they would be in the same after-tax position and accordingly would be as well remunerated for their capital. This would mean that the corporations required less revenue to service the capital and might therefore reduce prices.

In the case of closely held corporations this might also be true in that the shareholders probably look to their "take-home-pay". A tax saving of whatever nature becomes a reduction of cost and, depending upon competition and other factors, could result in decreased prices. A reduction in prices would make Canadian products more competitive in foreign markets. All this is purely conjecture, of course, but it does serve to point out that conclusions on all these matters cannot be definitely reached without considerable research.

Escape for Estates

A factor in favour of tax-exempt dividends which was not mentioned in the November issue was the incidence of estate taxes and income taxes together. Individuals owning a business are often forced to sell the company simply because the combination of estate taxes and income taxes upon their death makes retention of their business prohibitive. Present valuation rules of the Estate Tax Act not permitting a deduction for income taxes in the valuation of a company compound the problem. For these reasons, it is not uncommon to read in the press that another Canadian enterprise has been sold to nonresidents. The exemption of dividends from tax would permit individuals owning such corporations to draw out, at the time of their death, sufficient funds to meet estate tax and succession duty liabilities.

It may be that the political implications of tax-free dividends would completely negate any efforts towards such a solution. Nevertheless the purpose of the November article was to awaken interest in this important matter particularly insofar as it may serve to keep designated surplus before the eyes of the accounting profession. The concept of designated surplus is a natural outgrowth of the double taxation system and is only one of the many obstacles conceived by the taxation authorities to prevent surplus from being extracted from a corporation tax free to its shareholders.

The contest between taxpayers and tax collectors has now reached the point where arrangements are frequently made to get out the surplus completely free of tax. Typical of the plans which are considered before disgorging the surplus of a company are those which use non-voting and voting shares or the process of amalgamation. Not uncommon also is the incorporation of a holding company to control the shares of an operating company.

Experience suggests that as often as the battered designated surplus concept is repaired, it will spring a leak under the constant probing for its weaknesses by determined taxpayers. Unless designated surplus can be so firmly buttressed that every company must pay a tax on distribution, a very low rate of tax on surplus has much to recommend it. Assuming that legal and other expenses to extract designated surplus amount to about 5% of the surplus, even a tax of 5% would not be unrealistically low. Even if the rate were 10%, perhaps taxpayers would be content to pay the tax rather than go to the length they now do to escape the 20% tax.

THE LAW

Federal Income Tax Regulations

Changes have been made in the federal Income Tax Regulatons, as follows:

Terminal loss on assets

The allowance on disposal of a class (terminal loss) is also to be allowed in cases where all the property of a class is transferred to another class. This is effective in the 1960 and subsequent taxation years.

Proration of capital cost allowances in year of death

When a taxpayer dies, his capital cost allowances must be prorated according to the number of days of the taxation year or fiscal period that have elapsed to the day after the day of his death. This section became effective on November 9, 1960.

Depletion base for amalgamated companies

A new company formed by the amalgamation of two or more companies must, when computing its base for depletion, take into account its predecessor's exploration and development expenses that it had deducted as permitted by section 851(3). This section is retroactive to the 1958 taxation year.

Capital cost allowances—Class 2 (6%)

Property acquired for the purpose of processing natural gas before delivery to a distribution system is no longer depreciable under Class 2, with effect from November 9, 1960.

RECENT TAX CASES

Personal Corporations

The Supreme Court of Canada has upheld the decision of the Exchequer Court in the case of *Settled Estates Ltd.* The Supreme Court ruled that an executor or estate cannot be the person exercising control of a corporation in that the executor or estate is acting for others. Therefore, in order to determine whether a corporation is controlled by an individual or members of his family, the executor must be "looked through" to find out on whose behalf he is acting. Thus, if the beneficiaries of an estate consist of brothers and sisters only, the corporation controlled by the estate will not be a personal corporation. On the other hand, if the beneficiary happens to be an individual and members of his family, the corporation will be a personal corporation, provided that it meets the other tests laid down by section 68 of the Act.

(*Settled Estates Ltd.* v. *M.N.R.*)

Deductible Expenses

The appellant company was charged under the Criminal Code with unlawfully conspiring with other corporations to prevent or lessen competition in the manufacture and sale of fine papers. It was found guilty

and ordered to pay a fine. In addition, the company incurred legal expenses of some $6,000 and sought to deduct this amount from its income. The Minister disallowed the deduction on the grounds that as the company had been found guilty there could be no deduction for such expenses. Both the Minister and the Exchequer Court relied upon the Supreme Court's decision in *M.N.R.* v. *L. D. Caulk Co. of Canada Ltd.* In this case the deduction of legal expenses was permitted since the company had not been proven guilty. The Exchequer Court felt that there was no material difference between the facts relevant in the two cases and that the deduction of the legal expenses should be allowed. It was of the opinion that legal expenses incurred in defending trade practices until a final decision on their legality or illegality was reached were deductible as expenses incurred for the purpose of gaining income. It was immaterial whether the practice was lawful or not since the appellant was subject to tax on the income from its business and the legal expenses were incurred to defend its way of doing business and to preserve the system that helped to produce its income.

(*Rolland Paper Co. Ltd.* v. *M.N.R.*)

New Mine Exemption

The appellant company obtained a licence in the form of a lease on a large iron ore property in Northern Quebec and granted to the Iron Ore Company of Canada a sublease on a part of the property. The sublease called for the Iron Ore Company to pay the appellant a royalty on all iron ore shipped, computed as a percentage of the competitive market price. The royalty was not included in the appellant's income for 36 months on the grounds that it was income derived from the operation of a new mine. The Minister disallowed the exemption on the grounds that the mine was not being operated by the appellant and that its income was not from a mine but from a royalty agreement.

The Exchequer Court of Canada allowed the appeal stating that there was nothing in the wording of section 83(5) to indicate that the benefit contained therein is to be limited to the operator of the mine. Although the royalties came to the appellant pursuant to the sublease, neither the sublease nor the property right conferred by it brought the royalties into existence. The royalties arose by reason of the operation of the mine and were thus derived therefrom. Accordingly, they were exempt from tax for the first 36 months of operation of the mine.

(*Hollinger North Shore Exploration Co. Ltd.* v. *M.N.R.*)

OTHER CASES OF INTEREST

Dupère, D. Inc. v. *M.N.R.*
(60 DTC 560)

Purchaser of bakery business not allowed a deduction in respect to the portion of the sale price attributed to a list of customers. The court held that the taxpayer had received a lasting benefit by purchase of competitor's business and that the amount in question was considered as goodwill.

Eastern Abbatoirs Ltd. v. *M.N.R.*
(60 DTC 570)

Reimbursement of company's share of pension contributions ruled to be a receipt of capital on termination of plan. Receipt not a fruit of the business.

Equitable Acceptance Corp. Ltd. v. *M.N.R.*
(60 DTC 576)

Life insurance policies used to guarantee payment on loans ruled to provide a lasting benefit as collateral security.

Premiums deemed outlays prior to borrowing and not in the course of borrowing. Deduction disallowed.

Guest, Hamer v. *M.N.R.*
(60 DTC 604)

Personal loan from employer subsequently forgiven considered as a gift and not taxable as income from an office or employment.

No. 726 v. *M.N.R.*
(60 DTC 585)

Land sold by subsidiary to parent and re-sold for a substantial profit allowed as capital gain. Sale by parent considered to be of same nature as if subsidiary had sold. No question of taxable profit on sale of capital asset by subsidiary.

M.N.R. v. *Claude Rousseau*
(60 DTC 1236)

Salary and rent credited on books of company not taxable as income to shareholder employee. Credit on books considered not to be evidence of indebtedness or security of debt to determine right to receive by shareholder employee. Taxpayer taxable only on income received.

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Current Reading

MAGAZINE ARTICLES

AUDITING

"A New Look At the Approach to Auditing" by Reed L. Colegrove. *The New York Certified Public Accountant*, October 1960, pages 676-687.

In evaluating certain traditional auditing procedures, the author of this article, an American certified public accountant, questions whether they are all appropriate as to timing and scope in every examination and whether some of them are applicable at all on some engagements. His illustrations of standard procedures in the audit of cash, receivables, inventories, liabilities and revenue and expense accounts disclose that many auditors fail to exercise imagination in the performance of their tasks and perform many procedures that cannot be justified by the objectives of the audit.

The volume and timing of the auditor's work, writes Mr. Colegrove, are entirely dependent upon his review of his client's accounting procedures and internal control. The scope of the examination will also be influenced by the understanding between the auditor and his client as to the limitation on the auditor's responsibility for the discovery of fraud. With these two phases of the audit carefully evaluated, the auditor can then start to prepare the rest of his program. To replace many traditional procedures, such as the petty cash count, the author suggests a shift in emphasis. Specifically, he thinks considerable emphasis should be placed on procedural testing designed to evaluate the client's accounting procedures and internal controls, and on the audit of selected transactions rather than the examination of all documents for a selected period. Some of his suggestions may increase the time spent on an audit. All of them are designed to increase the effectiveness of the auditor's work.

FINANCE

"Organized Securities Exchanges in Canada" by J. E. Walter and J. P. Williamson. *The Journal of Finance*, September 1960, pages 307-324.

"The Stock Market in Canada" *Monthly Review*, The Bank of Nova Scotia, September 1960.

These two publications examine in fair detail a very important Canadian institution about which comparatively little has been written. The Walter-Williamson article discusses the structure of the exchanges in Canada, the behaviour of the exchange markets, interlisting with U.S. exchanges, and the pattern of security regulation in Canada. The bank letter traces the historical process from which the present structures emerged, and compares the exchanges in Canada with those in the United States.

With respect to the behaviour of the exchange markets, the most obvious feature is the high volume sustained by the Toronto, Montreal and

Canadian exchanges. At the Toronto Stock Exchange, which is reported to account currently for 80% of share trading on Canadian stock exchanges, the peak of trading in recent years (in 1955) was about 172 million shares a month. At the New York Stock Exchange, which accounts for about 70% of U.S. trading, the peak was 118 million shares a month.

There is a substantial amount of interlisting with U.S. exchanges. Eleven Canadian issues are traded on the New York Stock Exchange, and some 108 others are listed on the American Exchange. The New York Stock Exchange contributed 54.5% of the aggregate share volume of its 11 Canadian listings in 1957. In no category (industrials, mining and oil) does the American Exchange contribute less than one-third of the total volume of its Canadian listings. Industrials are reasonably well divided between the Toronto, Montreal, Canadian and American Exchanges; Toronto provides the major market for mining; the American exchange is most active in oil issues.

Canada has no federal securities legislation. Every province has a Securities Act, and in each case registration is required of public offerings of securities. On the whole, however, the pattern of regulation in Canada is unsatisfactory.

"COMMON STOCKS AS AN INFLATION HEDGE" by S. H. Archer. *The Analysts Journal;* September - October 1960, pages 41-45

When is a common stock a good inflation hedge? In answer to this question, some investment advisers would say, "when the value of a company's productive facilities and, hence, its common stock prices, rise as prices in general increase". The author of this article rejects this view with the argument that plant facility values and common stock prices are both related to a common factor — earning capacity. Inflation stocks should thus be selected, he suggests, on the basis of the anticipated behaviour of earnings during inflation.

Companies whose product prices are unresponsive to inflationary pressures are not good hedges against inflation. Others whose costs are highly flexible also have to be rejected since their earnings will not increase in keeping with prices in general. Only common stock in companies whose product prices are sensitive to inflation and whose costs reflect past prices should be regarded as inflation stocks. The older the costs matched against current revenue, and the larger the proportion of these costs to total costs, the greater is the tendency for the concern to have a rise in reported profits which may match or exceed the rise in the price level.

If Archer's definition of inflation stocks is accepted, then common stocks of banks, public utilities, rails, gold mining and soft drinks have to be rated poorly as inflation hedges on the basis of their inflexible product prices. Others, such as retail trade and apparel, have to be rejected because of a cost structure that is highly correlated with inflation.

Seventy-five industries, however, contain 50% or more companies whose per-share-earnings growth exceeded the increase in the Consumer Price Index from 1935-1955. Notable among these are several natural resource industries including oils, coppers, aluminums, sulphur producers, diversified metals, and lead and zinc. Also included in Archer's list of inflation-hedge industries are: soap manufacturing, finance and small loans, office machinery, paper, and shoe manufacturing.

MANAGEMENT

"AMERICA'S BEST - MANAGED COMPANIES" *Dun's Review and Modern Industry*, September, 1960, pages 38-40

Twenty-five or 50 years ago, the chief executives of America's leading corporations would have labeled some aspect of production as business management's major worry. Today, chief executives surveyed by *Dun's Review* rank marketing strategy, organization planning, and research and development as key factors in a company's success. Production techniques are rated fourth; financial management, fifth.

When management fails, say the presidents, it is in planning in the three crucial areas heading the list. Forty percent of the presidents believe the greatest weakness today is the failure to plan or forecast adequately. Twenty-three percent hold that it is the inability to change, to remain flexible enough to meet the problems of either the present or the future.

The opinions expressed by the presidents suggest a composite picture of a well-managed company that is prospering today and will continue to flourish in the years ahead. Regardless of size or age, it has a top management that is strong on long-range planning. It has management in depth, a well-defined organization structure, with clear delegation of authority and responsibility. Within the company, there is centralized policy control and decentralized operational control. Management is flexible in its attitudes, able to shift product lines to meet new demands, ready to back research, aggressive and imaginative in capturing markets and satisfying customers. Above all, this ideal company is working now to insure a supply of intelligent, aggressive executives for the future.

BOOK REVIEWS

"Cost Administration: Cases and Notes" by E. D. Bennett; published by Prentice-Hall Inc.; 596 pages; $10.00

Professor Bennett, of Harvard University, has applied that university's case study method to problems in cost accounting; production, inventory, and budgetary controls; feasibility studies for data processing systems; and the public accountant's and management consultant's position in relation to these problems. This is a very broad field to cover in the 37 cases cited. The result is a series of problems, without answers, supplemented by general notes on some of the techniques that could be employed. These notes are largely quotations from other authors.

The case studies are not supported by any comments or suggested solutions to the problems. It is therefore impossible for the reader to agree or disagree with the author's methods. The student in business administration will receive no guidance or instruction in the selection or application of the proper techniques for the solution of the problems. It must be assumed that the book was prepared primarily for use in conjunction with the author's lectures.

The amount of space devoted in each case to the company's historical background and the recorded comments of various officials illustrate some of the difficulties of the practitioner in defining business problems. The reader will find a generous list of references to articles in current periodicals on the subjects covered. Appended to each case are numerous

exhibits of forms and statements which assist materially in appraising the problems contained in the narrative.

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"Principles of Accounting — Advanced", (5th ed.), by H. A. Finney and H. E. Miller; published by Prentice-Hall, Inc., 1960; 834 pages; $11.35

The publication of this book completes a monumental task of writing five editions of a three-volume set of accounting texts. In addition, the introductory and intermediate books of the set have been published in Canadian editions and have professors of Canadian universities as co-authors.

The advanced book, like its predecessors, is lengthy, with an additional 240 pages of questions and problems related to the individual chapters. The Canadian reader will find the five chapters on insurance, receiver's accounts, estates and trusts and public accounts only of general interest because of differences in the underlying Canadian statutes and terminology. However, different statutes apply in the various states in the U.S.A. and the chapters are designed as an introduction to these subjects and only refer to the more important accounting and legal problems.

Of the 28 chapters, four are devoted to partnership and ten to parent and subsidiary accounts and their consolidation. In each case the treatment is very full, and it assumes no prior knowledge of the subjects. Throughout the book the authors illustrate situations that might arise in connection with a subject. This adds considerably to the length of the text and often appears to underestimate the intelligence of the reader. On pages 3 - 6 examples are given of a profit distribution to partners on the basis of equal shares, unequal shares, equal and unequal shares combined, capital at the beginning of the year, capital at the end of the year and average capital. Undoubtedly the authors would justify their treatment by saying that the book is used by students of varying abilities, and the good student can skip the obvious examples. In developing the problems of consolidations Bulletin No. 51 of the American Institute of Certified Public Accountants is considered, as are the complicated problems of multiple companies with inter-related holdings of shares.

Other chapters deal with venture accounts, consignments, installment sales, the statement of affairs, realization and liquidation reports, compound interest and annuities, home and branch accounting and foreign exchange. These topics are developed from the beginning without reference to the other books in the series. As a result, the treatment does not handle the subjects in the manner that a reader might expect from the word "advanced".

Authors of accounting series are faced with the dilemma of writing in such a manner that each book can be used by students who may not have used an earlier book in the series or who will not go on to a later book. Even where the students use the full series over a period of several years, it is impossible to keep all the books up to date. This is particularly important in respect to taxation, and since three books cannot be revised in less than five or six years, the tax aspects of the subject are usually ignored. This book is no exception, and the prospective reader should scrutinize the chapter headings to determine

whether the subject he is interested in is included. He should not assume that advanced accounting concepts are being argued and weighed and that the elementary work commenced in the previous books will be concluded herein. Nonetheless, the student who is concerned with accounting methods of the subjects mentioned will find a straightforward exposition that is exceptionally well written and easy to follow.

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145 Adelaide W.

"Bankruptcy Law of Canada", by L. W. Houlden and C. H. Morawetz; published by The Carswell Co. Ltd., Toronto, 1960; 510 pages; $21.00.

For all who may become involved in the subject of bankruptcy — and few members of the business community manage to escape nowadays —this new publication should prove helpful. In this volume, Carl Morawetz, the editor of previous texts on this subject, has joined forces with L. W. Houlden, and between them the authors have produced a work which is considerably more substantial than the usual annotated copy of the Bankruptcy Act with case references.

For the businessman there is a special introduction which describes the purpose and extent of bankruptcy legislation, and this, together with the careful explanations provided by the authors when reviewing the "definition" sections of the Act, will serve to dispel a great deal of the mystery surrounding bankruptcy.

The professional accountant will find useful the topical commentaries accompanying each related group of sections of the Act. These commentaries suggest the more important problems which are likely to be encountered and generally give clear-cut solutions based on case law and the authors' experience.

The banker should find extremely useful the information concerning the position of secured creditors under the Act, information which is most difficult to obtain from merely reading the Act itself.

The trustee will find the book considerably more helpful than many previous works chiefly because of the topical commentaries referred to, and also for the special "check lists" of trustee administrative procedures and the many useful precedents provided by the authors.

The solicitor will find this text to be a useful reference to the Act and the case law, and the review of the constitutional aspect of the law should be of particular interest. Not only the voluminous references to case law but the authors' comments throughout the book on matters which have yet to be decided by the courts should be of value.

In the reviewer's experience as a trustee, the problems which are most frequently raised in insolvency matters are perhaps as follows:

Landlord and insolvent tenant.

Illegal preference obtained by an individual creditor.

Status and rights of secured creditors.

Special rights of certain creditors by virtue of the Provincial Mechanics' Lien Acts.

In this text, the authors have provided a careful analysis of each of the foregoing subjects, and for these alone this work will be a worthwhile addition to the bookcase in every business and professional office.

A word of caution is appropriate.

The authors have produced a very readable text, and it would be quite easy for the uninitiated to assume that a comment or a case reference contained therein provides the whole solution to a specific problem. It should be remembered that bankruptcy is a complicated subject and that this is a legal text, not a "do it yourself" exposition. While it is written to be understood by the layman, it should certainly not be used by the professional accountant or student-in-accounts as a substitute for the opinion and advice of a competent solicitor.

J. L. BIDDELL, C.A.
Toronto, Ontario

224 Richmond W, Tor

BOOKS RECEIVED

"The Elements of Group Insurance" by G. N. Watson; published by The Institute of Chartered Life Underwriters of Canada, Toronto; 156 pages; $5.00

"The Elements of Insured Pension Plans" by Hall and Spurr; published by The Institute of Chartered Life Underwriters of Canada, Toronto; 136 pages; $4.50

Both books may be purchased from the publishers as a set for $9.00. While each publication was written for the chartered life underwriters' program of study, they will be of interest to anyone concerned with group insurance and group pension plans. An excellent source of reference, they can be readily understood by those who are not actuaries but who need to have a working knowledge of these subjects.

"CCH Canadian Sales and Excise Tax Guide", 11th ed., 1960-61; published by CCH Canadian Ltd., Toronto; 538 pages; $4.00

The 11th edition of this guide summarizes the law amended to October 1, 1960 and sets out the nature of liability for sales tax followed by an alphabetical list of exemptions. It also discusses computation of the tax, remittance, deductions and refunds.

"Double Taxation", by C. E. Garland and P. F. Hughes; published by Taxation Publishing Co. Ltd., London, 1960; 213 pages; 30/10d

This book covers all the double taxation agreements in force between the U.K. and other countries with reference to the machinery of credit relief, agreements with Eire, unilateral relief, exempt income and decided cases.

"CCH Workmen's Compensation" (3rd ed., 1960); published by CCH Canadian Ltd., Toronto; 609 pages; $6.00

This book contains the full text of each province's Workmen's Compensation Act as amended in 1960, as well as pertinent regulations. It also gives a comparative summary of the legislation introducing workmen's compensation and charts showing disability benefits, death rates and schedules of occupational diseases.

Publishers' Addresses

The New York Certified Public Accountant, 355 Lexington Ave., New York 17, N.Y.

The Journal of Finance, William W. Alberts, Graduate School of Business, University of Chicago, Chicago 37, Ill.

The Analysts Journal, 82 Beaver St., New York 5, N.Y.

Dun's Review, 99 Church St., New York 8, N.Y.

Monthly Review, Bank of Nova Scotia, 44 King St. W., Toronto 1, Ont.

Prentice-Hall Inc., Englewood Cliffs, N.J.

The Carswell Co. Ltd., 145 Adelaide St. W., Toronto 1, Ont.

The Institute of Chartered Life Underwriters of Canada, 224 Richmond St. W., Toronto 2B, Ont.

CCH Canadian Ltd., 1200 Lawrence Ave. W., Toronto 19, Ont.

Taxation Publishing Co. Ltd., 98 Park St., London W. 1, England.

Edited by D. C. R. HORNE, C.A.
Touche, Ross, Bailey & Smart, Montreal

Students Department

Solving Fund Statement Problems By the "T" Account Method

John R. E. Parker, C.A.,
Riddell, Stead, Graham & Hutchison

The income statement of a business entity portrays to its user a variety of information relating to the operating results of the business during the period covered by the statement. In conjunction with its related statement of surplus, the income statement explains the changes that have occurred in one item on the balance sheet, namely, retained earnings. The balance sheet, on the other hand, is in many respects analogous to a snapshot; it is a cumulative statement showing the financial position of the business as at the balance sheet date. Since the accounting period of a business entity is bounded by two balance sheets, it follows, therefore, that a comparative balance sheet is useful for presenting changes in balance sheet accounts. The source and application of funds statement, however, serves the additional purpose of explaining the changes that have occurred in the non-current balance sheet items. The changes in individual current asset and current liability accounts, although important in statement analysis, are better examined separately, probably in association with an examination of the current ratio. Only the net change in working capital as a single figure need be explained in a source and application of funds statement.

The "funds" referred to in the statement title are the various economic values that change hands in business transactions or that otherwise exist in the assets of a business. The purpose of the statement is to disclose the sources of working capital and the uses made of this working capital during a given period, usually a year. The source and application of funds statement is not a classified summarization of ledger account balances, as are the balance sheet and income statements. Essentially the preparation of a source and application of funds statement involves a rearrangement of data pertaining to changes in asset and equity items, together with an analysis and reconstruction of the account balances from which the balance sheet and income statement were prepared. One basic fact which many fail to realize is that changes in working capital are the result of changes in the various non-current accounts of the entity.

One of the principal sources of funds is, of course, provided by operations. In a strict sense the gross revenues received by a business constitute a source of funds, while the charges against revenue requiring an outlay of working capital are an application of funds. As a short-cut calculation, and in order to minimize repetition of income statement data, it is common practice to start with net income and adjust this amount for the various charges and credits not

affecting working capital. Accordingly, as a general rule, in all cases where the net income is used as a source of funds, adjustments must be made for items appearing on the income statement that do not involve an outlay or receipt of working capital. No adjustment is necessary for transactions not involving funds if, as is sometimes the case, these transactions are recorded through surplus.

Of the various techniques available for preparing a source and application of funds statements, the "T" account method is perhaps the most straightforward. Writing in *The Journal of Accountancy* of June, 1946, Professor William J. Vatter presented the first published description of this method. The procedure, with minor variations from that proposed by Vatter, is as follows:

1. Compute the net change in working capital. A schedule of working capital is not part of a source and application of funds statement; therefore, unless such a schedule is specifically required do not prepare one.
2. Set up a working capital "T" account and enter therein the net change in working capital. An increase in working capital is, of course, entered as a debit, while a decrease is shown as a credit.
3. Set up "T" accounts for each noncurrent item on the balance sheet and enter therein the net changes which have occurred during the period. The changes representing increases in debit balance accounts or decreases in credit balance accounts are entered as debits in the appropriate "T" account. Conversely, the changes representing increases in credit balance accounts or decreases in debit balance accounts are entered as credits. These changes are readily available when working from a comparative balance sheet; otherwise they are determined by subtracting the amounts in the opening balance sheet from those in the closing one.
4. Rule off the net changes recorded in the various "T" accounts. A single line across the account is satisfactory.
5. From analysis of available information reconstruct the transactions which brought about the net change recorded in each individual "T" account. All items appearing on the income statement that do not involve funds, together with all current asset and current liability items, are debited or credited as appropriate, to the working capital "T" account. A net income is debited to the working capital "T" account, while conversely a credit is made in instances involving a net loss.
6. After utilizing all the information available, any differences between the net changes recorded in the "T" accounts and the various amounts posted to the same accounts are interpreted in the most logical way.
7. Foot and balance all "T" accounts. Each "T" account should contain postings that in net total equal the change originally recorded in the account.
8. The source and application of funds statement is prepared from the information contained in the working capital "T" account. The sources of funds appear on the debit side of the account, the applications on the credit side.

Illustrative Problem

FINAL EXAMINATIONS, OCTOBER 1956

Accounting I, Question 4

The Directors of Y Co. Ltd. find that they are unable to pay the year end dividend to the shareholders without borrowing. They are puzzled as to the reasons for the small cash balance and weak current position since the net profit for the current year was the largest in the company's history.

CA has been engaged by the management of Y Co. Ltd. to assist in preparing an explanation of the situation for the directors. CA is given the following condensed balance sheets as at September 30, 1955 and 1956:

Y CO. LTD.
BALANCE SHEET
as at September 30

ASSETS	*1955*	*1956*	*Increase or (decrease)*
Cash on hand and in bank	$ 150,000	$ 40,000	$(110,000)
Accounts receivable (net)	345,000	550,000	205,000
Inventories	505,000	610,000	105,000
Prepaid expenses	20,000	35,000	15,000
Cash surrender value of life insurance policy	25,000	30,000	5,000
Investments	223,000	300,000	77,000
Investment in subsidiary company	175,000	190,000	15,000
Non-current advances to subsidiary company	—	25,000	25,000
Sinking fund cash held by trustee	5,000	7,000	2,000
Land	150,000	170,000	20,000
Buildings	450,000	550,000	100,000
Accumulated depreciation—Buildings	(92,000)	(148,000)	56,000
Equipment	502,000	845,000	343,000
Accumulated depreciation—Equipment	(160,000)	(290,000)	130,000
Patent rights	—	18,000	18,000
Organization expenses	50,000	40,000	(10,000)
Bond discount and expense	15,000	10,000	(5,000)
	$2,363,000	$2,982,000	

LIABILITIES			
Notes payable	$ 30,000	$ 60,000	$ 30,000
Accounts payable and accrued charges	385,000	654,600	269,600
Dividends payable	48,000	45,800	(2,200)
First Mortgage bonds Serial "A"	100,000	50,000	(50,000)
First Mortgage bonds Serial "B"	300,000	400,000	100,000
Capital stock—preference shares	400,000	450,000	50,000
Capital stock—common shares	700,000	720,000	20,000
Premium on issue of preference shares	6,000	7,000	1,000
Increment arising from appraisal of fixed assets	—	150,000	150,000
Reserve for contingencies	50,000	25,000	(25,000)
Earned surplus	344,000	419,600	75,600
	$2,363,000	$2,982,000	

CA's analysis of the accounts discloses the following information relating to the transactions during the year ended September 30, 1956:

(i) The company sold all its investments for $220,000 and invested $300,000 in securities providing a higher rate of return.

(ii) Dividends of $3,000 received from the subsidiary company were credited to "Investment in subsidiary company". The Y Co. Ltd.'s share of the subsidiary's net profit for the year – $18,000 – was charged to this account and credited to "Sundry income".

(iii) As at October 1, 1955, the fixed assets were appraised by an independent appraisal company. On this basis, the fixed assets and accumulated depreciation accounts were adjusted as at that date to reflect the following:

	Undepreciated value	*Depreciation*	*Net value*
Land	$ 170,000		$ 170,000
Buildings	550,000	$120,000	430,000
Equipment	620,000	220,000	400,000
	$1,340,000	$ 340,000	$1,000,000

The net increase was credited to "Increment arising from appraisal of fixed assets".

(iv) Additional equipment was purchased at a cost of $250,000.

(v) Equipment carried in the accounts at $25,000 less accumulated depreciation of $15,000 was sold for $12,000. The resulting profit was credited to "Profit on disposal of equipment".

(vi) $50,000 was deposited with the sinking fund trustee in cash. $50,000 Serial "A" Bonds were purchased from these funds for $48,000 and cancelled. The discount on retirement was credited to "Bond discount and expense".

(vii) The net of discount on retirement and unamortized bond discount and expense applicable to the Serial "A" bonds – $500 – was transferred from "Bond discount and expense" to "Profit on retirement of bonds".

(viii) $100,000 Serial "B" bonds were sold for $96,000.

(ix) 2,000 common shares of a par value of $10 each were issued for patent rights taken over.

(x) 500 preference shares of a par value of $100 each were issued and sold for cash.

(xi) The Company was defendant in a damage suit and the costs in connection therewith of $25,000 were charged to "Reserve for contingencies".

(xii) The summary of the earned surplus account was as follows:

	Dr.	Cr.
Balance October 1, 1955		$344,000
Net income for the year		150,000
Organization expenses written off	$ 10,000	
Dividends:		
Paid March 30, 1956	18,600	
Payable October 1, 1956	45,800	
Balance September 30, 1956	419,600	
	$494,000	$494,000

Required:

Statement of source and application of funds and the schedule of changes in working capital which CA would prepare for submission to the directors.

Suggested Solutions:

In the following suggested solution, the postings to the "T" accounts are keyed numerically to the journal entries. Those entries derived directly from the information given in the problem are identified. It will be noted that journal entries numbers 18 to 22 inclusive exemplify the reconstruction of "hidden" transactions. As previously indicated, such transactions require interpretation in the most logical manner.

Y CO. LTD.

SCHEDULE OF WORKING CAPITAL

	September 30		*Working Capital*	
	1956	*1955*	*Increase*	*Decrease*
Current Assets				
Cash	$ 40,000	$ 150,000		$ 100,000
Accounts receivable (net)	550,000	345,000	$ 205,000	
Inventories	610,000	505,000	105,000	
Prepaid expenses	35,000	20,000	15,000	
	$1,235,000	$1,020,000		
Current Liabilities				
Notes payable	$ 60,000	$ 30,000		$ 30,000
Accounts payable and accruing charges	654,600	385,000		269,600
Dividends payable	45,800	48,000	2,200	
	$ 760,400	$ 463,000	$ 327,200	$ 409,600
Working Capital	$ 474,600	$ 557,000		
Decrease in working capital	82,400		82,400	
	$ 557,000	$ 557,000	$ 409,600	$ 409,600

Working Capital

				82,400	
Investments sold	220,000	(1)	(2)	300,000	Investments purchased
Loss — investments	3,000	(1)	(4)	18,000	Share subsidiary profit
Dividends — subsidiary	3,000	(3)	(6)	250,000	Equipment purchased
Equipment sold	12,000	(7)	(7)	2,000	Gain — Disposal of equipment
Sale of bonds	96,000	(11)	(8)	50,000	Sinking fund deposit
Sale of preference shares	51,000	(13)	(10)	500	Profit — bond retirement
Net income	150,000	(15)	(14)	25,000	Damage suit
Depreciation	113,000	(20)	(17)	64,400	Dividends
Patents written off	2,.000	(21)	(18)	5,000	C.S.V. Life Insurance
Bond discount amortized	7,500	(22)	(19)	25,000	Advances to subsidiary
	657,500			739,900	
Balance	82,400				
	739,900			739,900	

C.S.V. Life Insurance

5,000	
5,000 (18)	

Investments

77,000	
300,000 (2)	(1) 223,000

Investment in Subsidiary Company

15,000	
18,000 (4)	(3) 3,000

Non-current Advances to Subsidiary Company

25.000	
25,000	

Sinking Fund Cash held by Trustee

2,000	
50,000 (8)	(9) 48,000

Land

20,000	
25,000 (19)	

Buildings

100,000	
100,000 (5)	

Accumulated Depreciation—Buildings

	56,000
	(5) 28,000
	(20) 28,000

Equipment

343,000	
118,000 (5)	(7) 25,000
250,000 (6)	

Accumulated Depreciation—Equipment

	130,000
15,000 (7)	(5) 60,000
	(20) 85,000

Patent Rights

18,000	
20,000 (12)	(21) 2,000

Organization Expenses

	10,000
	(16) 10,000

Bond Discount and Expense

	5,000
500 (10)	(9) 2,000
4,000 (11)	(22) 7,500

First Mortgage Bonds Serial A

50,000	
50,000 (9)	

First Mortgage Bonds Serial B

	100,000
	(11) 100,000

Capital Stock – Preference Shares

	50,000
	(13) 50,000

Capital Stock– Common Shares

	20,000
	(12) 20,000

Premium on Issue of Preference Shares

	1,000
	(13) 1,000

Increment Arising from Appraisal of Fixed Assets

	150.000
	(5) 150,000

Reserve for Contingencies

25,000 (14)	
25.000	

Earned Surplus

	75,600
10,000 (16)	(15) 150,000
64,400 (17)	

Supporting Journal Entries

(i)	1.	Working capital	$220,000	
		Working capital	3,000	
		Investments		$223,000
		Sale of investments, loss charged to profit and loss		
	2.	Investments	300,000	
		Working capital		300,000
		Purchase of investments		
(ii)	3.	Working capital	3,000	
		Investment in subsidiary company		3,000
		Dividends received from subsidiary company		
	4.	Investment in subsidiary company	18,000	
		Working capital		18,000
		Share of subsidiary's net profit credited to profit and loss		
(iii)	5.	Land	20,000	
		Buildings	100,000	
		Equipment	118,000	
		Accumulated depreciation – buildings		28,000
		Accumulated depreciation – equipment		60,000
		Increment arising from appraisal of fixed assets		150,000
		Adjustment re appraisal of fixed assets		

(iv)	6.	Equipment	250,000	
		Working capital		250,000
		Purchase of fixed assets		
(v)	7.	Working capital	12,000	
		Accumulated depreciation – equipment	15,000	
		Equipment		25,000
		Working capital		2,000
		Disposal of equipment, gain credited to profit and loss		
(vi)	8.	Sinking fund cash held by trustee	50,000	
		Working capital		50,000
		Deposit with Trustee		
	9.	First mortgage bonds Serial A	50,000	
		Sinking fund cash held by Trustee		48,000
		Bond discount and expense		2,000
		Bond retirement		
(vii)	10.	Bond discount and expense	500	
		Working capital		500
		Profit on retirement of bonds		
(viii)	11.	Working capital	96,000	
		Bond discount and expense	4,000	
		First mortgage bonds Serial B		100,000
		Bonds issued at a discount		
(ix)	12.	Patent Rights	20,000	
		Capital Stock – Common shares		20,000
		Common shares issued for patent rights		
(x)	13.	Working capital	51,000	
		Capital stock – Preference shares		50,000
		Premium on issue of preferred shares		1,000
		Preference shares issued at a premium		
(xi)	14.	Reserve for contingencies	25,000	
		Working capital		25,000
		Costs of damage suit		
(xii)	15.	Working capital	150,000	
		Earned surplus		150,000
		Net income		
	16.	Earned surplus	10,000	
		Organization expenses		10,000
		Organization expenses written off		
	17.	Earned surplus	64,400	
		Working capital		64,400
		Dividends		
	18.	C.S.V. Life Insurance	5,000	
		Working capital		5,000
		Increase in C.S.V. life insurance		
	19.	Non-current advances to subsidiary company	25,000	
		Working capital		25,000
		Advances to subsidiary company		
	20.	Working capital	113,000	
		Accumulated depreciation – Buildings		28,000
		Accumulated depreciation – Equipment		85,000
		Depreciation provided		

21. Working capital	2,000	
Patent Rights		2,000
Patents written off		
22. Working capital	7,500	
Bond discount and expense		7,500
Bond discount amortized		

Y CO. LTD.

Statement of Source and Application of Funds

year ended September 30, 1956

Funds provided

By operations			
Net income		$150,000	
Add: Charges not requiring funds			
Loss on sale of investments	$ 3,000		
Depreciation	113,000		
Patents written off	2,000		
Bond discount amortized	7,500	125,500	
		275,000	
Deduct: Credits not providing funds			
Share of subsidiary's profits	18,000		
Gain on disposal of equipment	2,000		
Profit on retirement of bonds	500		
Increase on C.S.V. life insurance	5,000	25,500	$250,000
Sale of investments			220,000
Dividends received from subsidiary			3,000
Sale of equipment			12,000
Sale of First Mortgage Bonds Serial B			96,000
Sale of preference shares			51,000
			632,000

Funds applied

Purchase of investments	300,000	
Purchase of equipment	250,000	
Deposited with sinking fund trustee	50,000	
Costs of damage suit	25,000	
Dividends	64,000	
Advances to subsidiary	25,000	714,400
Decrease in working capital		$ 82,400

References for Further Reading

Anthony, "Management Accounting", revised edition, Richard D. Irwin, Inc., 1960, chap. 12.

Holmes, Maynard, Edwards, and Muir, (3rd ed.), "Intermediate Accounting", Richard D. Irwin, Inc., 1958, chap. 27.

Horngren and Leer, "C.P.A. Problems and Approaches to Solutions", Prentice-Hall, Inc., 1959, pp. 197-204.

Greer, L. N., "The T Account Method for Solving Fund Statement Problems", *The Canadian Chartered Accountant,* May, 1953, p. 211.

Vatter, W. J., "Direct Method for Preparation of Fund Statements", *Journal of Accountancy,* June 1946, p. 479.

The "T" account method can, of course, be significantly shortened from that presented above. Most of the transactions affecting both working capital and non-current accounts can be posted directly to the appropriate "T" account without the preparation of supporting journal entries. As a minimum it is generally necessary to use "T" accounts for fixed assets, accumulated depreciation, and earned surplus, in addition to working capital. Depending on the circumstances, the other "T" accounts can usually be eliminated without adversely affecting the accuracy of the method.

* * *

The Panel

Due to rotation of membership and to an amended policy respecting the material appearing in this department, the composition of the panel of contributing members will change commencing with the March 1961 issue.

The change in policy is to return to publishing material more directly connected with the courses of instruction, rather than the fringe-interest subject matter such as that published in the past year. We trust this will enhance the value of our efforts to assist the student.

The new panel members, all of whom are chartered accountants fully engaged or experienced in the instruction of students, are keenly aware of the areas of study which can best be supplemented by this department. They are:

Robert N. A. Kidd, partner of McDonald, Currie & Co., Montreal.

Kenneth H. C. Laundy, director of staff training, Clarkson, Gordon & Co., Toronto.

Prof. C. L. Mitchell, University of British Columbia, Vancouver.

John R. E. Parker, director of staff training, Riddell, Stead, Graham & Hutchison (Montreal).

Prof. J. E. Sands, University of Toronto, Toronto.

Derek C. R. Horne, personnel manager of Touche, Ross, Bailey & Smart, Montreal (Editor).

A vote of appreciation is recorded here for the assistance so freely given by the following retiring members: W. H. Corner, D. H. Hall, M. Hubbell, K. A. MacKenzie, A. C. Ryley, and R. F. Selby.

NEWS OF OUR MEMBERS

Alberta

Watt, Gower & Ogilvie, Chartered Accountants, 10040 - 106 St., Edmonton, announce the admission to partnership of J. G. Olthuis, C.A.

John Devine, C.A. has been elected president of the newly organized Calgary chapter of the Institute of Internal Auditors. Other chartered accountants elected to office are James Currie, C.A. (secretary); William Drummond, C.A. (treasurer) and John Arkell, C.A. (governor).

British Columbia

Rickard, Crawford & Co., Chartered Accountants, announce the opening of an office for the practice of their profession at 93 Commercial St., Nanaimo.

A. A. Waring, C.A. announces the removal of his office to No. 811, 718 Granville St., Vancouver 2.

J. R. Bazell & Co., Chartered Accountants, announce the removal of their offices to Ste. 402, 434 W. Georgia St., Vancouver 2.

A. D. Hamilton, C.A., announces the removal of his office to 1013 - 675 West Hastings St., Vancouver 2.

Manitoba

Moran, Fenton & Co., Chartered Accountants, and E. D. Marchant & Co., Chartered Accountants, announce the merger of their practices. Henceforth the practice of their profession will be carried on under the firm name of Moran, Fenton, Marchant & Co., Chartered Accountants, with offices at 919 Grain Exchange, Winnipeg, and 511 St. Mary's Rd., Winnipeg.

J. W. Abbott & Co., Chartered Accountants, announce the removal of their offices to 301-373 Broadway Ave., Winnipeg 1.

New Brunswick

Lee & Martin, Chartered Accountants, announce the admission to partnership in their Fredericton office of J. A. Smallman, B.Com., C.A. and in their Saint John office of J. E. Cook, B.Com., C.A.

Nova Scotia

E. L. Pursey, C.A. has been appointed comptroller of Dominion Steel & Coal Corp. Ltd., Montreal.

Ontario

G. M. Feldt, C.A. announces the opening of an office for the practice of his profession at the Bathurst Towers Bldg., Ste. 301, 2828 Bathurst St., Toronto 19.

S. B. Baptie, C.A. has been appointed internal auditor of the Ontario Hospital Association, Toronto.

B. H. Cook, C.A. has been appointed provincial auditor for Prince Edward Island.

Murray Grossman, C.A. and F. L. Karp, C.A. announce the dissolution of the partnership of Grossman, Karp & Co., Chartered Accountants. The practice will continue under the name of Murray Grossman & Co., Chartered Accountants, with offices at 2828 Bathurst St., Toronto 19.

McColl, Turner & Co., Chartered Accountants, 362 Queen St., Peterborough, announce the admission to partnership of J. A. Naish, C.A.

Pollock, Lyttle & Co., Chartered Accountants, St. Catharines, announce the admission to partnership of R. D. Durward, C.A.

Chagnon, MacGillivray & Co., Chartered Accountants, 46 Jackson St. E., Hamilton, announce the admission to partnership of P. D. Green, C.A.

Campbell, Lawless, Parker & Black, Chartered Accountants, and Punchard, Grant & Co., Chartered Accountants, announce the merger of their practices. Henceforth practice of the profession will be conducted under the firm name of Campbell, Lawless & Punchard, Chartered Accountants, with offices at 159 Bay St., Toronto.

Continued on page 106

Continued from page 104

G. S. Edwards, C.A. has been appointed comptroller of Leo Contracting Co. Ltd., Downsview.

K. Eddis Greenwood, F.C.A. announces the opening of an office for the practice of his profession at 38 Berwick Ave., Toronto 7.

G. S. Pover, C.A. has been appointed controller of General Tire & Rubber Co. of Canada Ltd., Industrial Products Div., Welland.

Quebec

Gerald d'Amboise, c.a. annonce l'ouverture de son bureau à Carleton-sur-Mer, Bonaventure, pour l'exercice de sa profession.

Pierre Bachand, C.A. has been appointed comptroller and secretary of Walter M. Lowney Co. Ltd., Montreal.

D. M. Williams, C.A. has been appointed treasurer of Dalfen's Ltd. and its subsidiary Mary Morgan Inc., Montreal.

Greenshields & Co Inc has announced the appointment of Kenneth Hayes, C.A. as controller of its head office in Montreal.

J. A. Laing, B.Com., C.A. has been appointed a director of The Wawanesa Mutual Insurance Company.

N. R. Brining, C.A. has been appointed comptroller of Bushnell T.V. Co. Ltd., Ottawa.

OBITUARY

We regret to announce the death of the following member:

ALWYN WILFRED STEMPEL — A practising member for 32 years who died in Calgary on October 18, 1960. Admitted to the Saskatchewan Institute in 1928 and made a Fellow in 1940, he practised in Saskatoon and Lloydminster and was a past president of the Saskatchewan Institute. During World War II he served with the R.C.A.F. at Headquarters Command at Ottawa. In 1945 he joined the Alberta Institute and was associated with Harris, Fingarson & Co. in their Calgary office until his retirement in May 1960.

INSTITUTE NOTES

ONTARIO INSTITUTE

Proposed Merger with C.P.A. Association of Ontario

The following letter has been sent to all members of the Ontario Institute.

December 20, 1960

To all members:

In 1950 the members of The Institute of Chartered Accountants of Ontario and of The Certified Public Accountants Association of Ontario sponsored legislation to control public accounting in Ontario through the Public Accountancy Act. During the last ten years the two organizations have worked closely together and differences between our standards have been largely eliminated. However, the continuation of two professional organizations in the same field has created confusion in the minds of the public and is an impediment to our development and proper recognition as a profession. This has not been in the public interest.

With this in mind, a committee appointed by your Council has met with a committee appointed by the Board of Governors of the Association and reached general agreement as to the desirability of a merger of the two organizations, to be carried on as The Institute of Chartered Accountants of Ontario with a combined membership of 4962.

Agreement has been reached on the major policy matters and approved at meetings of the Council of the Institute on November 21, 1960 and of the Board of Governors of the Association on November 22, 1960.

The main matters of policy included in this agreement are:

1. *Membership of the merged groups*: All members of the C.P.A. Association of Ontario as of the date of the merger shall be admitted to membership of the Institute as Chartered Accountants.
2. The Ontario C.P.A. designation shall be given up and the rights to its use reserved to the merged body.
3. The merged body shall be known as "The Institute of Chartered Accountants of Ontario".
4. *Educational requirements for admission*: The Association recognizes and accepts that the Council of the Institute has approved in principle the requirement that, by 1970 at the latest, university graduation should be the minimum entrance standard for students-in-accounts.
5. Licensees under the Public Accountancy Act other than members or students of the qualifying bodies should be permitted to write the final examinations of the Institute, if they wish, and be eligible to apply for membership in the Institute, if successful.
6. All students of the Association of C.P.A.'s of Ontario at the date of the merger will have the right to continue their studies and type of experience, the qualification earned on satisfactory completion of their studies, experience and examinations being "Chartered Accountant".
7. *Provision of accounting education and designation(s) after the merger, for new students not in public practire*:

   (a) The Institute will, after the merger, accept as students, suitably qualified persons who concurrently secure experience such as is presently satisfactory to the C.P.A. Association, under the supervision of a member of the Institute. Such students on fulfilling study, length of experience and examination requirements of the Institute will receive a separate designation such as "A.C.A.". These students, upon graduation as members of the Institute will not be eligible for public accounting licenses without some minimum period of practical public accounting experience, upon completion of which they shall be entitled to the designation "C.A.".

   (b) The Council of the merged body will study the necessity of continuing to provide facilities for the training of accountants in industry.
8. *C.P.A. groups in other provinces*: The Institute recognizes the problem faced by the C.P.A. groups outside of Ontario and agrees to make the Chartered Accountant Institutes in the provinces concerned, aware of the formula which is adopted in Ontario. Further, the Institute agrees to bring such influence as it can to bear on the provincial C.A. Institutes concerned, in the hope that negotiations between the C.A.'s and C.P.A.'s or R.P.A.'s in those provinces will be undertaken.
9. *Council of the Institute*: Initially the Council of the merged organization shall consist of the 20 members of the Institute Council and the 15 members of the Association's Board, as of the date of the merger. The combined Council is to determine its own eventual make-up and whether any ratio of practising to non-practising members sitting on the Council, is to be established.
10. (i) Officers

    (ii) Staff and premises

    (iii) Funds

    (iv) Fees

    (v) Courses of Instruction

    These matters to be decided by the combined Council of the merged body, giving due consideration to the responsibilities of the Institute and the Association.

Representatives of the Institute and Association have been particularly concerned with the following points in reaching this agreement:

(1) The need to improve our standards in the profession through higher educational qualifications and instructional methods.

(2) The confusion that exists in the public mind as to the area in which professional competence is required and as a re-

sult confusion as to who is qualified to render service.

(3) Our responsibility to our present and future members and to the business community to continue to provide qualified personnel to hold top executive positions. It is in the interests of all to maintain the public recognition which our members in industry have received.

The Council of the Institute has authorized a committee to continue working with a committee of the Association to develop detailed plans. You will be kept informed as these plans emerge.

No final action, of course, will be taken before the plan is placed before a special meeting of the membership duly called to approve it.

In the meantime, it is proposed to hold meetings in some of the principal cities of the province under the auspices of Chartered Accountants' Clubs or as arranged by Council, to discuss the proposed merger. I would welcome written comments from any member who would like to let me have his views in order to guide us in our discussions.

W. J. AYERS—*President*

Members' Dance: Members responded to the change in the dance arrangements in magnificent fashion, with the result that the dance was sold out. (The capacity of the Canadian Room is 300 couples.) Comments received indicate that the form taken by the function this year is very acceptable and it seems apparent that in future these general arrangements will continue. The response was particularly gratifying to the president and to the Dance Committee.

Presentation of Certificates Ceremony: Members who qualified by examination in September 1960 will receive their certificates at a convocation to be held in the Royal York Hotel at 3 p.m. on Friday, January 13. There will be 220 new members admitted. Prizes won at the September examinations will be presented at this gathering rather than at the annual dinner. J. A. Wilson, F.C.A., president of the Canadian Institute, will give the address of welcome to the new members.

Annual Dinner: The 78th annual dinner will be held in the Canadian Room of the Royal York Hotel on Friday evening, March 10. Full details will be given to members as soon as arrangements are complete.

Advertisements for Staff: Practising members are reminded that some time ago the Committee on Professional Conduct issued a general direction in the matter of advertisements for staff. The committee emphasized at that time that such advertisements must be couched in objective terms, and that the use of subjective terms such as "excellent opportunity", "above-average salaries" and "progressive firm", among others, are considered objectionable. There has been a tendency recently for subjective terminology to re-emerge in members' advertisements for staff, and the committee therefore reiterates its previous statement on the subject.

NORTHWESTERN ONTARIO C.A. ASSOCIATION

The annual meeting of the Northwestern Ontario Chartered Accountants Association was held at the Port Arthur Golf and Country Club on November 29, 1960. The following executive were elected for the 1960-61 year: president, T. A. Saul; vice-president, J. H. Charnock; secretary-treasurer, J. F. Williams; directors, E. R. Seal and G. E. Garner. Walter Paanenen was awarded the Sir George A. Touche prize for the highest marks in the 1960 intermediate auditing examination, and John Barber was presented with the Northwestern Ontario Association's prize for obtaining the highest marks of the area in the 1960 Grade 13 examinations. Mr. J. A. Wilson, president of the Canadian Institute, made the presentations.

A committee was set up to prepare a brief for submission to the Canadian Institute on qualifications for entrance to the Chartered Accountants Course of Instruction.

CLASSIFIED ADVERTISEMENTS

All replies to box numbers should be sent to The Canadian Chartered Accountant, 69 Bloor Street East, Toronto 5, Ontario.

Rates: Positions wanted, $7.00 per column inch; Positions offered, $10.00 per column inch; Open rate, $17.00 per column inch.

Closing date is 11th of preceding month.

ADMINISTRATOR OF PROFESSIONAL COURSES required by Department of Extension, McMaster University; salary range $8,000 to $10,000.

Applications are sought from university graduates with a professional designation such as C.A., R.I.A., or C.P.A., and several years of successful experience as teacher or practitioner.

The candidate selected will be responsible for the administration of the correspondence instruction of some 5,000 students, which includes the supervision of approved changes in the lesson notes and methods of instruction, and the supervision of examination procedures. He will also be responsible for recommending changes in curriculum and course practice.

Replies should be directed to Director of Extension, McMaster University, Hamilton, Ontario.

1960 C.A. GRADUATE desires offers for positions anywhere in Canada. 5 years experience in medium sized C.A. firm. Age 26. Box 298.

EAST AFRICA: International firm of accountants has vacancies for young qualified men in Tanganyika and Nairobi. Starting salary up to £1,600 per annum, according to experience. Other terms include house assistance, medical and pension schemes, passage paid out and back and good leave arrangements. Purchasing power of East African pound is approximately $4.00. Applications in confidence to Box 293.

RECENT GRADUATE required by Toronto C.A. Experience in medium-sized firm preferred. Robert G. Appleton, 139 Bond Avenue, Don Mills, HI-4-4454.

ACCOUNTING PRACTICE: East central Ontario firm of chartered accountants wishes to purchase practice from practitioner contemplating retirement or transfer to other endeavours. Box 300.

CHARTERED ACCOUNTANT — age 38, would like a position with partnership prospects where interest in student training, writing and public speaking would be useful. Experience includes writing of professional articles, a tax column, public speaking and practice on own account. Box 296.

MEDIUM SIZE FIRM of chartered accountants in southern Ontario is interested in contacting a sole practitioner or small to medium size firm in southern Ontario interested in affiliating interests to mutual advantage. All replies will be acknowledged. Box 299.

CHARTERED ACCOUNTANT — 1956 graduate, B.Com., with broad experience, available on per diem basis in Toronto area. Box 280.

1960 GRADUATE available as a staff assistant to an intrepid financial officer in industry willing to take on a non Anglo-Saxon chartered accountant. Will re-locate. Box 297.

PARTNERSHIP (C.A.) 60 miles west of Toronto. Suitable for branch development or 50/50 partnership. Annual 30% increase reasonable expectation. Capital and/or fee introduction basis for negotiation. Box 295.

INTERMEDIATE STUDENT required for small firm. Ideal location and adequate salary for young married student. No travelling. Present staff aware of this advertisement. Reply to Box 294.

BARRISTERS AND SOLICITORS

MACLEOD, McDERMID, DIXON, BURNS, LOVE & LEITCH

Barristers and Solicitors

6th Floor, Hollinsworth Building - - - Calgary, Alta.

PITBLADO, HOSKIN & COMPANY

Barristers and Solicitors

900 Hamilton Building, 395 Main Street - Winnipeg 2, Man.

STEWART, SMITH & MACKEEN

Barristers and Solicitors

Roy Building - - - - - - - Halifax, N.S.

ROSS & ROBINSON

Barristers and Solicitors

Canadian Bank of Commerce Chambers - Hamilton, Ont.

GOWLING, MacTAVISH, OSBORNE & HENDERSON

Barristers and Solicitors

88 Metcalfe Street - - - - - - - Ottawa 4, Ont.

BORDEN, ELLIOT, KELLEY & PALMER

Barristers and Solicitors

The Bank of Canada Building, 250 University Avenue - Toronto 1, Ont.

McCARTHY & McCARTHY

Barristers and Solicitors

Canada Life Building, 330 University Avenue - Toronto 1, Ont.

McLAUGHLIN, MACAULAY, MAY & SOWARD

Barristers and Solicitors

302 Bay Street - - - - - - - Toronto 1, Ont.

STAPELLS, SEWELL, STAPELLS, PATTERSON & RODGERS

Barristers and Solicitors

112 Yonge Street - - - - - - - - - Toronto 1, Ont.

WRIGHT & McTAGGART

Barristers and Solicitors

67 Yonge Street - - - - - - Toronto 1, Ont.

DUQUET, MACKAY & WELDON

Barristers and Solicitors

The Royal Bank Building, 360 St. James Street West – Montreal 1, Que.

HOWARD, CATE, OGILVY, BISHOP, COPE,
PORTEOUS & HANSARD

Advocates, Barristers and Solicitors

Royal Bank Building - - - - - - Montreal 1, Que.

PHILLIPS, BLOOMFIELD, VINEBERG & GOODMAN

Barristers and Solicitors

464 St. John Street - - - - - Montreal 1, Que.

STIKEMAN & ELLIOTT

Barristers and Solicitors

505 Bank of Canada Building - - - Montreal 1, Que.

MacPHERSON, LESLIE & TYERMAN

Barristers and Solicitors

2236 Albert Street - - - - - - - Regina, Sask.

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